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Trends
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1987'S ROLLER COASTER RIDE - DOWNHILL

The securities industry got up on the right side of the bed as the year dawned. The first quarter brought record revenues and profits to the total spectrum of firm categories. The sunny mood, however, was darkened by the stormy bond markets of April and May. Preliminary results for the third quarter show only marginal improvement while October's events leave full-year results in question.

HIGHLIGHTS

1. No firm category escaped the securities industry's second quarter profit plunge of 74%. Profits collapsed for each category as follows:

National Full Line Firms:	-102%
Large Investment Banks:	- 82%
New York City-Based Firms:	- 67%
Regional Firms:	- 53%
Commission Introducing Firms:	- 16%
Discounters:	- 14%

2. Principal transactions, primarily bond trading, together with minimal expense paring were the main culprits for these declines.

3. Six month results show the industry's profit margin and ROE at their second lowest level of the Eighties. Annualized, 1987's first half ROE and profit margin, respectively, were 22.2% and 9.4%, both pre-tax.

4. Despite problems with the large firms, the Regionals, New York City-based firms, Discounters and Commission Introducing firms had strong six-month results.

5. The industry's pre-tax ROE of 22.2% for 1987's first half compared favorably to other broad based performance measures. Returns on investing in the S&P 500 for the half yielded 25.5%, the NYSE Composite yielded 23.5% and the NASDAQ Composite yielded a lower 21.7%.

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ONLY YESTERDAY

Was it only yesterday or eons ago when the financial press was churning out story after story on huge Wall Street salaries, a 3,000 Dow, and so on.

This month we've seen the tune change to tabloid titles along the lines of 1929 Crash, Financial Meltdown, Panic, etc. Recent events do tend to make an analysis of the securities industry in the first half of this year seem like a course in ancient civilizations. The trends, and the rules, all seem to have changed. After a week like that of October 19 when 2.3 billion shares changed hands at the corner of Wall and Broad, records may no longer seem meaningful. Still, that 2.3 billion shares was two-thirds the Big Board volume for the entire year 1974. Back in 1974, a turning point year for the securities industry when all the numbers began to grow and grow fast, average daily volume on the New York Stock Exchange was just under 14 million shares per day. During the week of October 19, it averaged about 460 million per day.

Now OTC traders weren't exactly on vacation that week either, handling over 1.2 billion shares. That's equal to NASDAQ's 1974 full-year volume. In 1974, average daily NASDAQ volume was under 5 million per day...that week it was about 245 million per day.

It's fair to say that the securities industry has been slightly busy of late. With this type of activity, the agency business is generating record levels of commissions. Back in 1974, commission revenue for the securities industry totaled $2.3 billion. Last year it was $10.5 billion and based on this year's first half, not even adjusting for recent volume levels, it will grow at least another $2 billion this year.

Now what about that first half, "Ancient Civilizations 101." The equity markets were bullish and then the big headlines were covering the second quarter's bond trading fiascos.

The enormous profits trading can generate for a firm has tantalized senior management into devoting more and more capital to this area of the business and even has them scrambling to find new sources of capital - Japan, going public, corporate partners, etc. - to throw at this area. Above average returns can be made where risk is involved - and trading is risk. However, with one-quarter of the securities industry's revenues dependent on this risk area, not to mention other risk areas, and only one-fifth of the revenues now coming from that nice safe commission business, things can go bad, and very bad, with adverse markets...and they did!

Table 1

STATEMENT OF INCOME
TOTAL SECURITIES INDUSTRY

(In $ Millions)

Revenues	87:Q1	87:Q2	% Change
Commissions	3,298.4	2,970.9	(9.9)
Trading Profits	3,878.5	1,868.2	(51.8)
Debt Portion	2,595.4	907.0	(65.1)
Investment Gains	769.2	294.4	(61.7)
Underwriting	1,448.6	1,479.3	2.1
Equity Portion	327.3	472.1	44.2
Margin Interest	699.5	849.0	21.4
Mutual Fund Sales	790.1	611.9	(22.6)
Fees, Account Supervision	375.2	454.7	21.2
Research	24.6	6.8	(72.4)
Commodities	245.4	420.9	71.5
Other Securities Related	2,460.0	3,020.3	22.8
Other Unrelated	661.3	627.1	(0.5)
Total Revenues	14,650.9	12,604.0	(14.0)
Expenses			
RR Compensation	2,570.7	2,296.1	(10.7)
Clerical Compensation	2,507.0	2,269.6	(9.5)
Partner/Officer Comp.	402.3	387.6	(3.7)
Other Employee Comp.	152.5	182.4	19.6
Floor (Commission/Clearing)	513.0	533.9	4.1
Communications	606.7	629.1	3.7
Occupancy & Equipment	619.1	657.8	6.3
Promotional Costs	272.0	292.2	7.4
Interest Expense	3,307.0	3,521.3	6.5
Errors/Bad Debts	126.4	202.7	60.4
EDP	175.5	179.3	2.2
Non-Recurring Charges	4.5	5.8	28.9
Regulatory Fees	78.0	84.7	8.6
Other	1,284.5	829.5	(35.4)
Total Expenses	12,619.5	12,072.0	(4.3)
Pre-Tax Net Income	2,031.4	532.2	(73.8)

PUTTING ALL YOUR EGGS IN ONE BASKET

When Wall Street's profits tumbled in the second quarter, it shouldn't have been too big of a surprise. When you have all, or at least most, of your eggs in one basket - in this case principal transactions, particularly bond trading - the basket will go sour when the market moves against you.

April's and May's spiking of interest rates, not in small part due to an attempt to strengthen the U.S. Dollar, caught many a firm with long positions in Treasuries, munis, mortgage-backed, and other fixed income instruments. The result - major losses at many firms and an across-the-board hit for everyone long in bonds!

The industry has been steadily gravitating towards principal transactions as the industry's prime revenue source for years. Trading and investments accounted for less than 10% of revenues whereas commissions generated more than half of all revenues in the early 1970s. The industry gradually shifted its revenue dependence from commissions to trading where recently about one-third of revenues were driven by principal transactions while only about one-fifth were derived from commissions.

This held true in 1987's record first quarter. One-third of that quarter's record $14.7 billion in revenues came from trading and investments. This translated into record quarterly profits of just over $2 billion. However, the rocky bond markets in the second quarter caused trading and investment revenues to plummet over $2.4 billion, or more than 50%, with a resultant 74% decline in profitability! These principal transactions, the new "bread and butter" business line thus fell to around 17% of all Q2 revenues...the lowest level on an annualized basis in a dozen years.

Most of the decrease came from bond trading. The net gain from debt trading collapsed to $907 million in the second quarter, down $1.7 billion or off 65% from the first quarter's $2.6 billion net gain! This accounted for the bulk of the $2 billion revenue drop-off which, when tempered by a $500 million reduction in expenses, translated into a $1.5 billion slash in net income - again, a jolting 74% drop!

Since the 10 National Full Line firms and the 10 Large Investment Banks (see Table 16 for firm category synopsis) accounted for 90% of the first quarter's bond trading gains and total trading gains, it should be no surprise that it is these same firms that experienced 90% of the overall drop in these revenue areas. But even though these large firms experienced the lion's share of the aggregate plummet, the havoc of the second quarter's trading losses on firms' bottom lines was not limited to these two groups of large firms.

For the NFLs, trading gains plummeted nearly $900 million, more than accounting for the $750 million drop-off in revenues and $525 decline in profits. In fact, the NFLs lost $13 million in Q2 vs. a $512 million pre-tax profit in Q1.

For the LIBs, principal transactions were down $1 billion from Q1; a steeper decline than the $766 million revenue shortfall and $475 million drop in profits would otherwise indicate.

The same held true for Regional firms. Principal transaction revenue dropped $105 million in the second quarter, shy of the $125 million revenue shortfall but outpacing the $92 million drop in profits.

For the New York City-based Regionals, principal transaction revenues nosedived by over $300 million. This compares to about a $240 million drop in both revenues and profits. These firms, however, took a bigger hit in the investment area vs the trading area...two-thirds of the fall off came from investment accounts.

Taking a look at the past 10 quarters (Table 2), it is graphically obvious that the performance of the securities industry in principal transactions (trading and investment gains) is highly correlated to total revenues and profits. In all but the fourth quarter of last year, whenever principal transaction gains rose from the previous quarter, or fell, revenues and profits moved in the same direction. More important, a majority of the time the level of movement of revenues and/or profits closely matched the level of movement in the principal transaction area!

Table 2

QUARTER TO QUARTER CHANGE IN PRINCIPAL TRANSACTION REVENUES VS TOTAL REVENUES AND PRE-TAX PROFITS

(In $ Millions)

Quarter	85:1	85:2	85:3	85:4	86:1	86:2	86:3	86:4	87:1	87:2
Principal	57	62	(452)	1216	1099	(1177)	(393)	(215)	1874	(2531)
Revenues	432	284	(393)	2756	1311	(445)	(711)	1208	1691	(2047)
Profits	431	91	(318)	767	476	(619)	(266)	101	865	(1499)

Commission revenues fell 10% in the second quarter to $3.0 billion from $3.3 billion, mirroring the decline of activity on the major exchanges as well as the OTC market. Based on SIA's "Investor Activity Report," purchases and sales on the NYSE, AMEX and NASDAQ during the second quarter fell two billion shares short of the amount transacted in the first quarter.

Underwriting revenues, on the other hand, were surprisingly up (although by only 2%) since the volume of corporate and municipal offerings in the second quarter was $98 billion, down 20% from the first quarter's $122 billion (Table 3). Equity underwritings picked up the most; revenues were up 44% to $472 million, although equity underwriting volume only rose 5% to $17 billion, many more smaller-sized deals took place.

Table 3

UNDERWRITING VOLUME

(In $ Billions)

Security	87:Q1	87:Q2	% Change
Municipal Bonds	32.6	29.9	(8.3)
Corporate Bonds	73.5	68.2	(23.7)
Corporate Equity	15.9	16.7	5.0
Total	**122.0**	**114.8**	**(5.9)**

Source: IDD Information Services

Margin interest revenue was one of the few areas of revenue growth in the second quarter. Climbing $150 million from the first quarter's $700 million, or 21%, the improvement was due to two factors. First, margin debt balances, as reported by the NYSE, rose $3 billion in the second quarter to $39 billion. On that bigger base, the second quarter's higher interest rate environment, which was a downside to trading, compounded the rate of return for margin interest. On the other hand, the gain was wiped out by over $200 million more in interest expense (which is partially incurred to finance customers' margin debit balances) which shows that despite Charles Lamb's theory that "the human species is composed of two distinct races, the men who borrow, and the men who lend," there's no such segregation in the securities industry.

Quarterly mutual fund revenues fell for the first time since 1985, down 23% to $612 million which is also the lowest quarterly total since 1985. According to the Investment Company Institute, sales of open-end mutual funds (which this FOCUS revenue line tracks) also fell substantially, down 27% in the second quarter to $51 billion.

Besides asset management and commodities businesses, which showed higher returns in the second quarter of this year, "other securities related" businesses showed a healthy 23% increase or over half a billion more in revenue dollars during the second quarter.

This revenue line's main contributors are revenues from repo and reverse repo activities and from two investment banking areas: merger & acquisition fees and private placement fees.

M&A activity didn't contribute to the revenue increase. According to IDD Information Services, M&A transaction volume fell 30% in the second quarter to $31.6 billion from $43.3 billion in Q1. The number of transactions was also down, 888 in Q2 vs. 1030 in Q1. W.T. Grimmm & Co., the Chicago-based merger consultants, says that net M&A announcements in the second quarter were the lowest quarterly figure since they began tracking this field 24 years ago.!

The outlook for these revenues for the balance of the year looks flat. Third quarter M&A activity was brisk but screeched to a halt during October's market massacre. Ironically, the market crash began in takeover stocks when arbitrageurs unloaded due to the uncertainty of takeover legislation, including proposed limitations on of the tax deductibility of interest on bonds issued to finance takeovers.

This situation could, however, reverse and reverse rapidly when legislative uncertainties are settled in light of the current drastically reduced market prices of almost all public companies.

Private placement activity, on the other hand, was up sharply in the second quarter. IDD's data shows second quarter private placement volume more than tripling to $43 billion from $14 billion. The number of placements also came close to tripling going from 312 deals in Q1 to 874 in Q2.

On the flip-side of the income statement, total expenses also fell from the first quarter's record level of $12.6 billion. But the drop, only 4% or $1.5 billion, fell far short of revenues' decline leaving the bottom line down 74% from Q1's record $2 billion to $532 million.

Compensation costs' reductions mirrored declines in production levels. With compensation the single biggest expense of this industry, had this expense not been curtailed as revenues declined, industry results would have been even more disastrous. Further reductions in this main expense will occur, particularly during this final quarter, based on the employment reductions now underway.

Other than compensation, however, basically every other expense item increased during the second quarter - a situation which is intolerable if a bottom line is to be salvaged in even rougher times. Interest expense, as mentioned earlier, increased with interest rate levels. Other expense items, such as floor expenses, communications, occupancy and equipment, etc., rose marginally but again did so as revenues were plummeting.

Although third quarter figures are not yet available, reports from publicly held firms indicate this situation may not have alleviated much and the fourth quarter has gotten off to a horrendous start with 1929-style markets in October.

Table 4

STATEMENT OF INCOME
NATIONAL FULL LINE FIRMS

(In $ Millions)

Revenues	87:Q1	87:Q2	% Change
Commissions	1,444.5	1,225.1	(15.2)
Trading Profits	1,658.3	796.0	(52.0)
Debt Portion	1,088.0	429.0	(60.6)
Investment Gains	71.0	54.6	(23.1)
Underwriting	718.2	652.9	(9.1)
Equity Portion	167.3	237.6	42.0
Margin Interest	372.5	421.3	13.1
Mutual Fund Sales	563.0	426.4	(24.3)
Fees, Account Supervision	157.1	201.3	28.1
Commodities	133.8	261.1	95.1
Other Securities Related	854.2	1,186.5	38.9
Other Unrelated	110.0	104.1	(5.4)
Total Revenues	6,082.8	5,329.2	(12.4)
Expenses			
RR Compensation	1,525.6	1,407.0	(7.8)
Clerical Compensation	1,255.4	1,133.0	(9.7)
Partner/Officer Comp.	64.8	54.8	(15.4)
Floor (Commission/Clearing)	122.0	131.0	7.4
Communications	359.9	367.4	2.1
Occupancy & Equipment	351.9	371.5	5.6
Promotional Costs	151.2	158.5	4.8
Interest Expense	1,035.1	1,162.1	12.3
Errors/Bad Debts	88.9	137.4	54.6
EDP	60.1	60.9	1.3
Non-Recurring Charges	4.0	4.9	22.5
Regulatory Fees	41.6	50.7	21.9
Other	509.9	303.0	40.6
Total Expenses	5,570.5	5,342.2	(4.1)
Pre-Tax Net Income	512.3	(12.9)	(102.5)

NATIONAL FULL LINE FIRMS POST IN THE RED

Only one group of firms posted an annual loss as a group this decade: the 10 National Full Line firms (NFLs) which lost $118 million (pre-tax) in 1984. The NFLs also were the only group to post in the red in this year's tough second quarter. Revenues fell 12% while expenses declined a much smaller 4% for a 103% dive in bottom line results from $512 million in pre-tax profits in Q1 to $13 million in losses in Q2 - a $525 million decrease.

As mentioned earlier, the NFLs' trading gains plummeted nearly $900 million, more than accounting for the $750 million drop-off in revenues and $525 million decline in profits. In underwriting, the NFLs experienced a 9% decline in revenues in the second quarter, more in line with what happened in underwriting volume than the industry's 2% revenue increase. The decline means that these 10 firms captured 44% of total underwriting revenues in Q2 vs. 50% in the first quarter.

Margin interest revenues grew 13% for the NFLs which lagged the industry's 21% climb while drop-offs in mutual fund revenues mirrored the industry's decline.

Asset management (fees), commodities and "other securities related" revenues increased at slightly better rates than the industry as a whole leaving the NFLs' total revenue decline of 12% slightly less severe than the industry's 14% drop.

On the expense side of the income statement, the NFLs tracked the industry with declines in compensation matching production drops but with increases across the board in all other expense lines. Overall, the NFLs' 4% rise in expenses matched the industry's increase.

Table 5

PRE-TAX PROFIT MARGINS

(In Percent)

Firm Category	80	81	82	83	84	85	86	87*
National Full Line	10.9	6.9	8.8	8.6	(0.9)	5.6	6.9	4.4
Large Investment Banks	17.7	15.4	17.4	16.7	11.4	14.6	13.5	8.8
Regionals	14.7	11.2	11.1	12.6	2.6	9.4	11.0	9.6
New York City Based	14.8	12.6	14.0	18.3	8.9	12.3	16.1	17.7
NYSE Discounters	17.5	12.2	13.6	14.0	0.3	8.9	15.7	17.4
Commission Introducing	16.9	10.9	15.9	18.8	9.5	19.8	22.1	28.0
Total Industry	14.1	10.8	13.1	12.9	5.2	10.7	11.0	9.4

*First half

As the previous table shows, for the half the NFLs are running with a razor thin pre-tax profit margin of 4.4%, the lowest level of the 80s sans 1984's loss.

The NFLs' pre-tax return on equity, as the above table shows, was nearly halved in the first half to 11.7% from last year's 20.3%. Again, it was the worst showing, sans 1984, for this group during the 80s. The results are also only half the industry norm and are again the lowest showing of all firm categories.

Table 6

PRE-TAX RETURN ON EQUITY

(In Percent)

Firm Category	80	81	82	83	84	85	86	87*
National Full Line	45.0	24.6	29.8	28.1	(2.6)	17.9	20.3	11.7
Large Investment Banks	55.7	56.7	54.8	43.8	31.1	38.5	34.2	18.4
Regionals	N.A	37.2	36.0	40.5	6.8	29.0	32.7	27.2
New York City Based	N.A	42.1	43.3	50.7	19.9	31.2	35.4	38.9
NYSE Discounters	N.A	52.2	53.9	46.7	0.8	25.6	49.5	43.9
Total Industry	**49.2**	**35.9**	**40.5**	**36.6**	**13.3**	**29.4**	**28.6**	**22.2**

*First Half

The industry's employment of equity in doing a securities business returned 22.2% before taxes during the first half. If it had employed all of its equity in investing in the stocks of various broad indexes it in most cases could have done only slightly better. As Table 7 shows, investing in these broad indexes would have given returns of between 20% and 30% (which would also be pre-tax until liquidated), close to the industry's ROE and several groups of firms far exceeded these returns.

Table 7

FIRST HALF 1987 PERFORMANCE MEASURES

(In Percent)

Index	% Change
Dow Jones Industrial Average	+27.56
Standard & Poor's 500	+25.53
Standard & Poor's 400	+30.38
NYSE Composite	+23.45
NASDAQ OTC Composite	+21.74
AMEX	+28.44
Value Line	+19.05
Wilshire 5000	+23.41

Table 8

STATEMENT OF INCOME
LARGE INVESTMENT BANKS

(In $ Millions)

Revenues	87:Q1	87:Q2	% Change
Commissions	465.7	421.4	(9.5)
Trading Profits	1,559.2	637.3	(59.1)
Debt Portion	1,243.4	391.4	(68.5)
Investment Gains	181.4	66.5	(63.3)
Underwriting	511.0	568.2	11.2
Equity Portion	66.7	117.7	76.5
Margin Interest	110.3	153.8	39.4
Mutual Fund Sales	12.5	13.6	8.8
Fees, Account Supervision	73.3	103.4	41.1
Research	14.3	0.4	(97.2)
Commodities	88.6	122.2	37.9
Other Securities Related	969.6	1,167.1	20.4
Other Unrelated	306.0	272.4	11.0
Total Revenues	4,292.0	3,526.4	(17.8)
Expenses			
RR Compensation	440.9	331.3	(24.9)
Clerical Compensation	665.4	599.7	(9.9)
Partner/Officer Comp.	167.5	161.6	(3.5)
Floor (Commission/Clearing)	103.8	115.8	11.6
Communications	102.1	114.2	11.9
Occupancy & Equipment	120.0	135.1	12.6
Promotional Costs	57.9	68.6	18.5
Interest Expense	1,583.0	1,645.6	4.0
Errors/Bad Debts	12.2	48.3	295.9
EDP	57.3	58.5	2.1
Regulatory Fees	10.6	9.5	(10.4)
Other	390.4	132.0	(66.2)
Total Expenses	3,711.1	3,420.1	(7.8)
Pre-Tax Net Income	580.9	106.3	(81.7)

LARGE INVESTMENT BANKS HIT HARD

The 10 Large Investment Banks (LIBs) had a disastrous second quarter as Table 8 illustrates. Revenues nosedived 18% while expenses were only curtailed by 8% causing the bottom to fall out of profits - an 82% pre-tax plummet to $106 million in the second quarter.

Principal transactions, that sharp two-edged sword, showed its uglier half when revenues from this source crumbled by $1 billion in Q2. Over 85% of that drop came from bond trading alone.

Commission revenues' 10% decline matched the industry's shortfall; however, the LIBs were able to show revenue improvements from almost all other sources. Underwriting's profits rose 11% while the equity portion mushroomed by 77%, margin interest climbed nearly 40% and account supervision fees showed similar improvements.

Nonetheless, the LIBs couldn't weather the Titan-missile-size hit principal transactions sustained in the second quarter. The damage from the $1 billion slamming of revenues more than wiped out other gains for a total drop in revenues of $766 million and a $475 million clipping of profits.

As was true with the industry, the pairing of expenses in the second quarter was almost entirely from the compensation levels paid. But these curtailments were not enough to offset the broadside in principle businesses.

So, the second quarter's damage sunk the LIBs' first half profit margin and ROE to levels below the industry norm for the first time in the Eighties and to their lowest levels (on an annualized basis) this decade!

Table 9

STATEMENT OF INCOME
REGIONAL FIRMS

(In $ Millions)

Revenues	87:Q1	87:Q2	% Change
Commissions	482.9	441.4	(8.6)
Trading Profits	268.9	176.7	(34.3)
Debt Portion	113.2	72.9	(35.6)
Investment Gains	21.2	8.3	(60.8)
Underwriting	150.8	196.4	30.2
Equity Portion	61.8	95.2	54.0
Margin Interest	67.6	74.8	10.7
Mutual Fund Sales	194.9	156.3	(19.8)
Fees, Account Supervision	24.0	27.0	12.5
Research	2.2	5.2	136.4
Commodities	11.0	15.0	36.4
Other Securities Related	124.8	125.6	0.6
Other Unrelated	25.5	22.7	(11.0)
Total Revenues	1,373.8	1,249.3	(9.1)
Expenses			
RR Compensation	393.1	365.2	(7.1)
Clerical Compensation	248.7	209.4	(15.8)
Partner/Officer Comp.	80.2	90.0	12.2
Other Compensation	28.0	38.1	36.1
Floor (Commission/Clearing)	64.6	61.5	(4.8)
Communications	78.9	79.4	0.6
Occupancy & Equipment	64.6	61.7	(4.5)
Promotional Costs	32.4	33.9	4.6
Interest Expense	86.4	98.7	14.2
Error/Bad Debts	12.3	8.5	(30.9)
EDP	20.1	20.5	2.0
Non-Recurring Charges	0.2	0.8	300.0
Regulatory Fees	9.5	9.9	4.2
Other	82.1	91.2	11.1
Total Expenses	1,201.5	1,168.8	(2.7)
Pre-Tax Net Income	172.3	80.5	(53.3)

REGIONALS RIDE OUT THE WAVE

For Regional firms, the bad news is - profits were slashed in half during the second quarter. The good news is - that's not as bad as the 103%, 82%, 74% and 67% drops experienced by the NFLs, LIBs, the total industry and the New York City-based regionals, respectively.

Principal transaction revenues fell $105 million in the second quarter, nearly the entire $125 million total revenue shortfall for Regionals. Commissions, which make up a hefty 35% of Regionals' total revenues, their number one revenue source, fell 9%, the same percentage drop as total revenues from Q1 to Q2.

Mutual fund sale revenues, also an important contributor to revenues, 13% to 14% of late, were also hit relatively hard in the second quarter - dropping 20%. Everything else, however, fared well. Underwriting revenues rose 30% overall with equity's portion up 54% in Q2. Margin interest climbed 11%, asset management fees rose 13% while commodities revenues increased by more than one-third.

Rollbacks in expenses such as compensation, floor costs and errors and bad debts during the second quarter, which were cut by about $50 million, were offset by increases of around $20 million in other expenses, more than half of that from interest costs alone.

The result was that expenses were pared by about $30 million while revenues were slashed by $125 million which cut profits in the second quarter in half.

The following table shows, however, that the Regionals did not fare as well as the industry and the LIBs in the first quarter but outperformed these groups in the second quarter as well as the total six month period.

Table 10

PRE-TAX PROFIT MARGINS

(In Percent)

Firm Category	87:Q1	87:Q2	YTD
National Full Line	8.4	(0.2)	4.4
Large Investment Banks	13.5	3.0	8.8
Regional Firms	12.5	6.4	9.6
New York City-Based Firms	24.3	9.7	17.7
NYSE Discounters	18.8	16.0	17.4
Commission Introducing Firms	30.5	25.4	28.0
Total Industry	13.9	4.2	9.4

In fact, as Table 5 showed earlier, Regionals' profit margins on an annual basis since 1980 have always lagged the LIBs and only last year did they catch up to the industry average. So, for the first time, based on the first six months, Regionals' profit margins now exceed the LIBs and the industry average.

The story is similar for the Regionals' pre-tax ROEs. As another earlier example showed, Table 6, Regionals' annual ROEs during the 80s always lagged the LIBs and often lagged the industry average. Table 11 below shows that for both the first and second quarters as well as the half, the Regionals' ROE has for the first time outpaced that of the LIBs and also outpaced the industry average. And the first half's results are pretty much in line with the ROEs the Regionals have experienced during the past two years of the bull market.

Table 11

PRE-TAX RETURN ON EQUITY

(In Percent)

Firm Category	87:Q1	87:Q2	YTD
National Full Line	24.6	(0.6)	11.7
Large Investment Banks	31.4	5.5	18.4
Regional Firms	37.6	17.1	27.2
New York City-Based Firms	61.8	17.6	38.9
NYSE Discounters	53.5	35.1	43.9
Commission Introducing Firms	73.5	48.2	58.6
Total Industry	36.1	8.9	22.2

Table 12

STATEMENT OF INCOME
NEW YORK CITY-BASED REGIONALS

(In $ Millions)

Revenues	87:Q1	87:Q2	% Change
Commissions	396.0	380.0	(4.0)
Trading Profits	268.7	162.2	(39.6)
Debt Portion	86.4	14.1	(83.7)
Investment Gains	227.2	30.2	(86.7)
Underwriting	38.6	26.2	(32.1)
Equity Portion	22.2	10.0	(55.0)
Margin Interest	39.5	59.1	49.6
Mutual Fund Sales	14.5	10.8	(25.5)
Fees, Account Supervision	71.7	73.9	3.1
Research	1.4	0.6	(57.1)
Commodities	3.0	11.3	276.7
Other Securities Related	275.5	332.5	20.7
Other Unrelated	117.2	126.7	8.1
Total Revenues	1,453.2	1,213.6	(16.5)
Expenses			
RR Compensation	130.6	123.2	(5.7)
Clerical Compensation	198.1	183.8	(7.2)
Partner/Officer Comp.	47.3	34.6	(26.8)
Other Compensation	58.7	65.6	11.8
Floor (Commission/Clearing)	75.2	79.6	5.9
Communications	33.1	34.4	3.9
Occupancy & Equipment	40.4	43.9	8.7
Promotional Costs	16.1	18.6	15.5
Interest Expense	348.6	366.4	5.1
Error/Bad Debts	4.4	3.6	(18.2)
EDP	12.5	13.4	7.2
Non-Recurring Charges	0.2	0.1	(50.0)
Regulatory Fees	7.9	7.4	(6.3)
Other	127.2	121.1	(4.8)
Total Expenses	1,100.5	1,095.5	(0.5)
Pre-Tax Net Income	352.8	118.1	(66.5)

NEW YORK CITY-BASED REGIONAL FIRMS

Commissions, which make up about 30% of the New York City-based Regionals' (NYCs) revenues, fell slightly, 4%, in the second quarter. Trading, however, dropped by $107 million, a 40% decline. That put trading at only 13% of the NYCs' Q2 total revenues, down from 18% in Q1.

Investment gains, which made up 16% of all first quarter revenues, almost dried up completely in Q2, plunging 87% or by nearly $200 million. A revenue source which contributed 16% of Q1 total revenues provided only 2% in Q2.

Combining these two principal activities, there is a drop of over $300 million from Q1 to Q2, far outpacing the $240 million drop in total revenues and the $235 million drop in pre-tax profits.

Looking at it another way, principal transactions accounted for one-third of the NYCs' total revenues in the first quarter but only 15% in Q2!

"Other Securities Related" revenue, again M&A, private placements and repos making up the bulk, climbed 21% for the NYCs in Q2. In the second quarter, this revenue source made up over one-quarter of the NYCs' total revenues, second only to commissions' 31% contribution.

Overall, revenues were down nearly 17%, a further drop than the industry's 14% shortfall. Total expenses, however, remained level, falling a mere one-half percentage point or $5 million.

Wile revenues were slashed by $240 million, compensation dropped only $28 million. A full $18 million of that cutback was offset by rising interest expense. The bottom line was cut by two-thirds from Q1 to Q2.

As was true with their Regional cousins, the NYCs, helped by a phenomenal first quarter, still have pretty good first half results. Their six-month profit margin of 17.7% was better than all their annual results during the Eighties except for 1983's 18.3% showing. Their annualized first half ROE of 38.9% was also their best showing since 1983.

Still, despite the six-month profitable results, the NYCs reliance on trading, investments and fees, such as M&A, does not bode well with what is currently happening to these business lines in the second half!

Table 13

STATEMENT OF INCOME
NYSE DISCOUNTERS

(In $ Millions)

Revenues	87:Q1	87:Q2	% Change
Commissions	176.7	174.2	(1.4)
Margin Interest	40.0	50.1	25.3
All Other	86.1	83.5	(3.0)
Total Revenues	302.8	307.8	1.7
Expenses			
Total Compensation	74.6	75.5	1.2
Floor (Commission/Clearing)	44.9	41.9	(6.7)
Communications	13.2	12.7	(3.8)
Occupancy & Equipment	11.7	14.5	23.9
Promotional Costs	6.9	6.2	(10.1)
Interest Expense	33.5	41.1	22.7
Error/Bad Debts	2.5	1.6	(56.3)
EDP	12.5	14.6	16.8
All Other	46.0	50.5	9.8
Total Expenses	245.8	258.6	5.2
Pre-Tax Net Income	57.0	49.2	(13.7)

NYSE DISCOUNTERS HANG TOUGH

Although all firm categories showed profit declines during the second quarter, the NYSE Discounters experienced the least - down less than $8 million or 14%. In fact, their revenues increased nearly 2% despite a small drop in their prime revenue source, commissions. What caused the drop was an increase in expenses. All categories discussed so far showed at least some expense reduction in the second quarter, albeit reductions short of the reductions in revenues. Discounters experienced 5% higher expenditure levels in Q2 which is not a good sign when markets are moving against you.

A positive sign, although their stock prices do not reflect it, is that the Discounters will be helped, at least temporarily, from the huge amount of agency commission business, which is more than half their revenue base, experienced so far in the second half. The downside of this, however, is that this group's primary customer base, the retail investor, may be scared out of the markets by October's fiasco for some time to come. Only time will tell.

For the first six months, Discounters' profit margins and ROEs, as seen in earlier tables, also were very healthy and outpaced the industry averages.

Table 14

STATEMENT OF INCOME
COMMISSION INTRODUCING FIRMS

(In $ Millions)

Revenues	87:Q1	87:Q2	% Change
Commissions	128.7	128.2	(0.4)
Trading Profits	49.9	53.0	6.2
Investment Gains	23.6	10.2	(56.8)
Underwriting	8.6	14.5	68.6
Fees, Account Supervision	14.4	10.0	(30.6)
All Other	24.6	37.9	54.1
Total Revenues	249.8	253.8	1.6
Expenses			
Total Compensation	69.4	79.8	15.0
Floor (Commissions)	22.3	23.3	4.5
Interest Expense	4.5	6.3	40.0
All Other	77.3	79.9	3.4
Total Expenses	173.5	189.3	9.1
Pre-Tax Net Income	76.3	64.5	(15.5)

COMMISSION INTRODUCING FIRMS

Commission Introducing firms (CIs), whose common thread is that they don't carry or clear for their customers' accounts, do not belong in any of the previous categories and file an abbreviated short form FOCUS Report, mirrored the Discounters performance. These firms also receive over half their revenues from the agency commission business and thus will be affected in much the same way that Discounters will be by recent events.

The CIs saw a slight drop in commission revenues but managed a slight increase in total revenues from Q1 to Q2. Their expenses rose 9%, however, for a bottom line drop of 16% in Q2.

Their profit margin for the first half, however, exceeded their annual profit margins in all of the Eighties.

Table 15

SECURITIES INDUSTRY CONCENTRATION

Total Revenues	80	81	82	83	84	85	86	87*
Top 10	53.1%	55.6%	57.3%	54.4%	58.8%	57.5%	57.3%	53.4
Top 11-25	19.4	18.7	18.7	19.6	17.1	19.7	19.8	20.9
Rest of Industry	27.5	25.7	24.0	26.0	24.1	22.8	22.9	25.7
	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
Total Capital								
Top 10	50.8%	50.0%	54.8%	52.8%	57.2%	63.2%	61.9%	59.9
Top 11-25	18.0	19.7	18.3	18.8	15.6	14.8	16.0	15.9
Rest of Industry	31.2	30.3	26.9	28.4	27.2	22.0	22.1	24.2
	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%

*Based on first half

CONCENTRATION EASES

As the above table shows, the 10 largest capitalized firms have been giving up, albeit slightly, some of their market share of industry revenues and capital the past few years. The middle tier, the 11th through 25th largest capitalized firms, have been basically holding steady. Both groups' aggregate revenues and capital have been growing, and growing rapidly, but the non-25 largest have been growing even faster, helped somewhat by the addition of more firms to the NYSE over the past few years.

GLASS-STEAGALL

The banking industry of late has stepped up its campaign to garner additional securities powers. Cries of unprofitability and inability to compete with Wall Street for profitable business lines have been lamented. The additional powers banks now seek - commercial paper, municipal revenue and asset-backed bond underwriting chief among them - are only a fraction of the securities business and based on the cutbacks in these areas by major securities firms (who say these areas are unprofitable) it's doubtful how these powers will help banks' bottom lines much.

These business lines are dominated by the largest firms in the securities industry. Let's assume that banks had full securities powers, in fact let's assume that they had the entire businesses of the largest securities firms. How profitable would the banks have been in the first half of this year? The following table shows how the top 10 and top 25 banks would have fared by absorbing the profits of their much smaller cousins.

Clearly, taking over the total business and profits of the 25 largest securities firms (which we just previously saw account for three-quarters of all securities industry revenues) doesn't even dent the fender of the runaway freight train of losses bank mismanagement has sent out of control. But banks are presently targeting just the businesses which large major securities firms are finding unprofitable for themselves.

Table 16

BANKS VS. BROKERS*

First Half 1987
(In $ Millions)

	Profits	Capital
Top 10 Firms		
Banks	(8,439.4)	80,568.0
Brokers	843.4	20,379.3
Combined	(7,596.0)	
Top 11-25 Firms		
Banks	(1,938.5)	39,421.1
Brokers	283.0	5,417.5
Combined	(1,655.5)	
Top 25 Firms		
Banks	(10,377.9)	119,989.1
Brokers	1,126.4	25,796.8
Combined	(9,251.5)	

* Largest bank holding companies by assets, American Banker, 9/30/87. Largest New York Stock Exchange member broker/dealers by capital. Profits are after tax.

This call to end "Glass-Steagall" as a panacea for bank unprofitability is false. A lot of securities firms took a beating in the recent market collapse and one bank, despite the banking industry's promises of separate subs with arms length transactions, violated its maximum one-customer lending ceiling with loans to prop up its securities subsidiary's troubled capital position during the recent crises. It's one thing to claim conflicts of interest can be managed and another to stand idly by while your subsidiaries are teetering.

George R. Monahan
Assistant Director of Research

Table 17

FIRM CATEGORY SYNOPSIS

NFLs	10 largest full service (all brokerage/investment banking, retail institution business lines) with a national branch network system.
LIBs	10 largest investment banking houses. Similar to NFLs in business lines except their client base is predominantly institutional with a resultant absence of many retail services. Also, no meaningful branch network - just money center cities.
Regionals	Similar to NFLs in business lines but much smaller in their size. Also, their branch network systems are mainly localized (Midwest, Southwest, West Coast, etc).
NYC Regionals	New York City-headquartered firms which are similar to Regionals but with a heavier institutional client base and thus more fee and investment income dependent.
Commission Introducing	Introduce commission business but don't carry or clear their own customer's accounts. This group is segregated mainly because they file a short-form (FOCUS) which is not comparable to the long forms. Not a homogenous group other than they are non-carrying and file the short FOCUS.
Discounters	Firms which hold themselves out as discount brokers with retail commissions their dominant revenue source.
Other	All firms which do not meet the criteria for the previous categories (boutiques, specialists, one-product line operations).

VOLUME

	SEPT 1987	YTD 1987	SEPT 1986	YTD 1986	% CHAN YTD 1987-1986
AVERAGE DAILY SHARE VOLUME ON					
NYSE (MILS.)*	177.3	181.1	150.8	140.3	29.1%
AMEX (MILS.)*	12.4	13.7	10.8	12.2	12.0%
NASDAQ (MILS.)*	148.3	149.9	105.4	116.2	29.0%
REGIONAL EXCHANGE (MILS.)*	N/A	N/A	23.4	23.1	N/A
DOLLAR VALUE OF SHARES TRADED ON					
NYSE (MILS.)	$163,895	$1,426,618	$124,644	$1,023,761	39.4%
AMEX (MILS.)	4,222	40,585	3,230	32,639	24.3%
ODD-LOT SHARES PURCHASED ON NYSE (THOUS.)	9,481	96,452	8,304	81,475	18.4%
ODD-LOT SHARES SOLD (INCLUDING SHORT SALES) ON NYSE (THOUS.)	15,465	157,856	16,716	161,118	-2.0%
NYSE BLOCK VOLUME AS A PERCENT OF TOTAL SHARES TRADED	49.8%	51.3%	47.9%	49.3%	----
CONTRACTS TRADED (THOUS.)					
CBOE OPTIONS	17,784	146,633	17,758	140,501	4.4%
AMEX OPTIONS	4,733	41,165	3,940	37,181	10.7%
COMMODITY	22,408	171,523	17,122	142,349	20.5%

*MONTHLY AVERAGE
N/A - DATA NOT AVAILABLE

UNDERWRITING

	NINE MONTHS 1987	NINE MONTHS 1986	% Change 1987-1986
CORPORATE FINANCING (Gross New Issues - $ Mils)			
TOTAL	$227,679.5	$202,250.4	12.6%
Common Stock	$35,167.7	$30,727.0	14.5%
# of Common Stock Issues	757	882	-14.2%
Preferred Stock	$10,987.5	$9,970.1	10.2%
# of Preferred Stock Issues	153	128	19.5%
Corporate Debt	$181,524.3	$161,553.3	12.4%
# of Corporate Debt Issues	1,326	1,255	5.7%
MUNICIPAL FINANCING (Gross New Issues - $ Mils)			
Negotiated	$57,659.8	$83,378.7	-30.8%
# of Issues	2222	2333	-4.8%
Competitive	$18,903.3	$27,781.9	-32.0%
# of Issues	2426	2965	-18.2%

Source: IDD Information Services

PRICES
(END OF MONTH)

	SEPT 1987	SEPT 1986	% CHAN YTD 1987-1986
DOW JONES INDUSTRIALS	2596.28	1767.58	46.88%
STANDARD & POOR'S 500	321.83	231.32	39.13%
NYSE COMPOSITE	180.24	133.44	35.07%
AMEX MARKET VALUE INDEX	356.45	260.69	36.73%
VALUE LINE COMPOSITE	279.41	222.08	25.82%
NASDAQ COMPOSITE	444.29	350.67	26.70%

RECENT INTERESTING READING AND STATISTICAL MATERIAL

Item	Description	Source
Report on Office Salaries	SIA annual survey report outlines weekly, monthly, and annual base salary information as of July 1, 1987 for 78 non-exempt administrative, secretarial, sales assistant, clerical, and "back office" positions. This 221-page report also illustrates historical trends data and presents detailed listings of salary levels in New York and in 27 major metropolitan areas.	William Jordan SIA Price: $ 50 participants $ 400 non-participating members $1,200 non-SIA members
Report on Management & Professional Earnings	SIA annual survey report details base salaries and bonuses of 128 middle management and professional positions. The report covers management and supervisory personnel in all operations departments as well as the professionals such as auditors, programmers, systems analysts, corporate finance associates, research analysts, and traders. This 321-page study also includes Human Resources Management positions such as compensation managers and analysts, benefits managers and analysts, and interviewers. Data as of 12/31/86 and 5/1/87 are presented.	William Jordan SIA Price: $ 50 participants $ 400 non-participating members $1,200 non-SIA members
"Villain or Scapegoat?--The Heat's on Program Trading"	If the market's crash were to spell the end of program trading, there will be a certain irony. Article explains program trading and portfolio insurance and how during the week of the 19th, program trading--at least as the term is understood by most Wall Streeters--failed to play its normal role.	Barron's 10/26/87

"1987 Nine-Month Corporate Finance Ratings"	During the first three quarters of the year, the total number of issues brought to market fell 1.3% to 2,236 from the same period in 1986, while overall dollar volume rose 12.6%. This is in sharp contrast to the same period for 1986 versus 1985. Moreover, the overall totals for the year to date reportedly would have been softer without the execution of deals using interest rate or currency swaps. Ranking tables includes new category, collateralized securities.	Investment Dealer's Digest 10/5/87
"Wall Street's New Austerity"	Review of reasons for recent cutbacks--retrenchments, job cuts and asset sales--by major securities firms as well as banks. Series of short articles also focuses on Salomon Brothers and the securities industry's impact on New York City.	Business Week 10/26/87
"No More Handouts"	So far this year, broker payout cuts have been mild compared with last year. Most firms left their schedules untouched or instituted only minor changes. Nevertheless, pressures remain especially for low-end producers. Article part of special compensation section.	Registered Representative October 1987
"Moving out from under Paul Volcker's shadow"	A look at the ideology and personality of the president of the New York Fed, E. Gerald Corrigan.	Institutional Investor September 1987

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Securities Industry
Trends
AN ANALYSIS OF EMERGING TRENDS IN THE SECURITIES INDUSTRY
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REPORT ON THE STATE OF THE SECURITIES INDUSTRY

(Address by Adrian L. Banky and Jeffrey M. Schaefer
before the SIA Annual Convention, December 3, 1987)

Our purpose will be to take a look at how our industry is doing. For the most part, we'll be examining 1987 in the context of how the securities industry has fared throughout the 1980s.

Since we'll be covering a lot of ground, we've put together some visuals that will help us zero in on the most significant trends and results. These exhibits treat such aspects as:

- The investment climate during the 1980s.
- The growth of the business.
- Revenues, costs and profitability.
- Retail and investment banking activity.
- Foreign participation in our markets.
- And, we'll also take a look at some of the impacts of the October 19 period--including sharing with you the results of a just completed mini survey on what firms are doing to stimulate business and to cut costs.

Since the exhibits contain a lot of information, we will focus on the most significant elements of each exhibit.

First, to provide a frame of reference, let's take a look at the general climate in which you have been operating.

(Exhibit 1) Our first graph depicts average daily share volume on listed and NASDAQ markets from 1981 through this October. The key point here, which comes across dramatically on the graph, is that over the past six years growth in secondary market trading of equities has been, in a word, spectacular. For the period shown, the rate of growth in volume works out to about 28%. That is, indeed, truly spectacular.

(Exhibit 2) Now let's look at stock prices during this same period. Here you see the S&P 500 index. If we assume we'll end the year above 242--and we're at 229 on December 7--that will mean two things. First, for the period 1981 through 1987, stock prices at year end will have increased each year over the prior year. Second, the compounded average rate of increase over the six years will come in at 13%. The key point we want to make here is that during the 1980s, and even with the October break, we have enjoyed very healthy increases in stock prices.

Now, given the fact we have had spectacular growth in trading volume and healthy increases in stock prices, let's look at what's been happening within our industry per se. (Exhibit 3) No surprise, seat prices on the NYSE have escalated sharply, reaching an all-time high of $1,150,000 earlier this year. Even using the $700,000 at which a seat recently traded, that represents a 146% increase over the $285,000 high of 1981.

(Exhibit 4) Here's another manifestation of good times. This next graph shows the sharp growth in the number of people employed in our industry. As you can see, we have experienced an unbroken pattern of increases in employment each year since 1981, reaching 451,000 at the end of August. The key point here is this: we've added a tremendous number of people during the 1980s. That means greatly increased manpower to cope with periods of high activity...and, of course, it also means greatly increased payrolls that work against us in periods of reduced activity.

Because personnel costs are so important, let's look at another slide that really dramatizes the growth in our work force. (Exhibit 5) Here we see how the percentage growth in our industry's employment over the past five years compares with that of other sectors of financial services. In short, there is no comparison. Our 64% growth dwarfs that of the banking and insurance industries. It is substantially greater than in real estate and consumer credit. And, it is four times greater than the 16% growth in the non-agricultural segment of our economy. Again, the key point here is a huge increase--at least up to about six weeks ago--in the most important asset, and the most important expense element, within the business--its people.

Accompanying the growth in the industry during the 1980s in total revenues, have been dramatic changes in the relative importance of different revenue sources. (Exhibit 6) One of the most important changes has been in trading profits and investment accounts--the top line on the graph. Trading and investment revenues used to be a fairly minor component of total revenue. But in the 1970s these revenues grew in importance to where, during the 1980s, they have ranged from

24% to 29% of all revenues. A second major change has been the decline in importance of commissions--shown as the line in the middle of this exhibit. This trend also started in the mid-1970s and continued into the 1980s. The bottom line on the slide tracks "revenues related to the securities business"--which grew dramatically. It includes for the most part M&A fees, private placement fees, and interest from repurchase agreements. Probably the biggest implication of these changes is that the volatility of trading profits and investment accounts has increased the volatility of both revenues and profits in the securities industry.

(Exhibit 7) On this graph, we see that despite some very profitable years, profit margins have been deteriorating through the 1980s. Look at the bars representing the total industry. Whereas pre-tax profit margins averaged 12% from 1981 through 1983, margins have declined to under 9% from 1984-3Q 1987. This declining trend in pre-tax profit margins is true across all firm categories -- National Full Line firms, Large Investment Banking firms, and Regional firms. Even the Large Investment Banks, who were the most profitable segment of the industry, have felt the deterioration. The key point here is, despite the seemingly good years we have enjoyed, margins have been shrinking throughout our industry.

(Exhibit 8) Moving away from profit margins, this exhibit shows a similar deterioration in pre-tax return on equity through the 1980s. The bars representing the total industry show that whereas industry pre-tax ROEs averaged 38% from 1981 through 1983, pre-tax ROE declined to about 23% from 1984 through 1987. If the year 1984 is ignored, the downward trend of steadily declining ROEs generally holds across all firm categories from the early 1980s to date. Again, even the Large Investment Banks experienced this deterioration despite being the most profitable segment of the industry until 1987.

(Exhibit 9) This exhibit shows that the dramatic decline in ROEs occurred at the same time industry equity capital was increasing impressively. Equity capital increased from $7 billion in 1981 to $26 billion by the third quarter of 1987; the increase has been particularly noticeable since 1985 as many brokerage firms went public or otherwise obtained additional capital. The key point is this: As capital has expanded, the industry has had to assume more risk and work harder and harder to generate the same level of returns as in earlier years--and it has failed to do so. Nevertheless--and this is important--for most of the 1980s, the securities industry has outperformed most of American industry in general. Any comparison would show that the securities industry has been among the most profitable segments of American industry.

Having just seen the deterioration in industry profitability, let's look at our industry's expense structure to see if we can find some linkages to the bottom line. (Exhibit 10) Shown here are our industry's two biggest expense elements. The top line is compensation. The lower line is interest expense. Both elements are expressed as a percent of total revenues. In combination, they account for about two-thirds of all expenses. So, these are the biggies. There are three key points for your attention. First, look at how compensation has edged upward through the 1980s: from 32% to 38%. The point here is that people costs have become a much more important factor in your expense structure...and in your profitability. Next look at the volatility in interest expense. For example, look at 1983 and 1984...and you see interest costs rocketed from 21% of revenues in 1983 to 31% in 1984. The key point here, which could have some [illegible] implications for the future, is that interest costs can be absolutely brutal during periods when activity softens and interest rates trend upward. This is something you will want to watch very closely. The third point concerns how dramatically compensation and interest costs impact profitability. As we saw just a bit ago, our most profitable year was 1982. No coincidence, compensation and interest costs were the most favorable that year, representing just 58% of revenues. In sharp contrast to that 58%, these two elements came in at 67% for the first three quarters of this year. The key point here is if you want to do something significant on expenses, you really need to look hard at compensation and interest. To lean on the cliche, "that's where the money is."

While we're on the subject of costs, let's now look at the results of a mini survey we conducted about fifteen days ago to get a flavor of what firms are doing to address cost concerns. We talked to 15 firms, representing a variety of sizes, types and locations. (Exhibit 11) As you can see:

- Four indicated that thus far they had made no real changes.
- Four others had recently made some selective cuts.
- Three had gone much farther, having made fairly widespread, significant cuts.
- And, four said they had instituted major, sweeping cuts throughout their firms.

Assuming these 15 firms are generally representative, the key point here is that cost cutting has become the order of the day--with about half the firms having already instituted significant or major reductions. If anything, that trend has intensified in the last ten days.

What sorts of cost reductions are firms making? (Exhibit 12) Here's a list drawn from the 15 firms we surveyed. As you can see, a lot of attention is being given to people costs, including:

- Layoffs
- Not replacing those who depart
- Freezes on new hires
- Salary increases
- Rethinking of bonuses and sales comp.
- Some terminations of non-productive RRs
- And, restrictions on overtime

But, various other kinds of cost reductions are being implemented, including such old favorites from yesteryear as travel, entertainment, publications and so on.

(Exhibit 13) Let's turn our attention to underwriting activity. As you can see from this exhibit, total issuance of new securities has been subject to cyclical swings, particularly in the municipal sector, which explains a lot of what is going on recently in terms of cutbacks in this area of the business. The municipal sector exploded in growth in 1985, with about $243 billion in municipal securities floated. This compares with a mere $77 billion through the first three quarters of 1987. Much of this has to do with the Tax Act of 1986, which restricted many of the activities that had previously been financed through the issuance of municipal securities. The IPO market has never really recovered from 1983, except possibly for 1986, while corporate bond issuance will probably about equal that for last year. The important point is that the total amount of securities offered in 1987 will be less than 1986 and might even be less than that of 1985.

(Exhibit 14) Here we see a graphic illustration of the growing importance of the foreign investor to U.S. securities markets. Foreign holdings have soared from $233 billion in 1981 to $651 billion, an increase of almost 280%. Most of this increase was in Treasuries as well as corporate and Yankee bonds. More recently, however, there has been a dramatic increase in foreign holdings of equities as stock prices rose and as foreign investors were increasingly attracted to this investment vehicle in recent years. Naturally, all these numbers are subject to change with the recent market crash, but it will not change the basic trend of increased foreign holdings of U.S. securities over time. Furthermore, preliminary data indicate foreigners remained net buyers of stock in October, although their enthusiasm waned somewhat. The main point, though, is simply this: Foreign money has become very important to our markets.

(Exhibit 15) This graph zeroes in on the importance of foreign investors to the equities part of our U.S. markets. This exhibit compares the gross issuance of new equity offerings to the net purchases of U.S. stocks by foreign investors. In 1986 and 1987, foreign investors' net purchases have surged to over $18 billion per year and are major factors relative to the gross offerings of new equities in the U.S. market. Given the redemptions of equity by corporations in terms of corporate buybacks, debt-for-equity swaps, etc., there are less equities outstanding today than there were several years ago. In effect, there has been a surge in foreign buying while the supply of U.S. stocks has dwindled in recent years. Thus, the key point is that foreign purchases of U.S. equities have become an even more significant factor both in the U.S. equities market and in terms of their impact on U.S. equity prices.

Let's now turn to the retail side of the business. (Exhibit 16) This next chart is both interesting and somewhat surprising. What it does is track average retail RR production from 1980. The top line gives the mean; the lower line, the median. First, let's look at our estimates for the full year 1987--shown at the right. The large national firms will average about $265,000 this year and the regionals about $185,000. In turn, we project an industry-wide average of $240,000--which is not much different from last year. You may wish to compare those numbers with your own. The second point to which we direct your attention is the somewhat surprising one. Note that mean production has risen from $146,000 to an estimated $240,000 this year. That seems like quite a rise, but it actually works out to an annual increase of only 7%. The 7% is no doubt influenced by a lot of new RRs coming into production. But even so, the 7% growth in productivity strikes us as not terribly satisfactory when one considers that the period we're looking at was outstanding in both volume and prices, and when we then further factor in the huge investments made in sales- support costs to increase broker productivity. The key point, then, is this: Increases in retail broker productivity do not seem to compare very favorably with increases in production-related costs. This is something that deserves to be looked at closely.

What about the here and now? As we all know, retail activity in just a few weeks has swung sharply from very heavy to very light. At a recent meeting of SIA's Sales and Marketing Committee we asked what firms are doing to stimulate their sales forces. (Exhibit 17) Shown in this exhibit are just a few of the approaches noted.

o Some are having virtually every broker call virtually every account--to discuss portfolios, the outlook, investment ideas and so on.

o Some are calling those customers who are nearing possible margin calls. This provides the opportunity to explore portfolio shifts or additional cash. And, it reduces the chances of having to implement margin calls later.

- Year-end tax-oriented programs are a focus in many firms.
- Some are letting their brokers know how much business they need to do between now and year end to move up on the grid.
- The use of investment managers.
- Daily sales ideas for newer brokers who haven't experienced this kind of market before.
- New advertising and sales promo campaigns have been launched by some.
- A few firms noted they are making sure their RRs are not distracted or facing financial problems as a result of their own investments.
- And, new accounts campaigns were mentioned by several.

(Exhibit 18) This exhibit dramatizes the impact of October on the world's securities markets. In effect, capitalization on the New York Stock Exchange plunged from $2.9 trillion to about $2.3 trillion in that one month alone. Although other countries had significant drops as this shock was felt throughout the world, the declines in Tokyo and other industrialized countries nowhere matched that on the NYSE. This was somewhat surprising because many experts anticipated that if stock markets were overvalued, the beginning of the trouble would originate from Japan, where many believed that market was the most overpriced of all!

(Exhibit 19) To put the market decline in perspective, it is interesting to compare the drop in the NYSE with the capitalization of other stock markets throughout the world. As this exhibit shows, the $617 billion decline on the NYSE alone was equal to the combined market capitalizations of the German, Canadian and French stock markets as of the end of September, and just trailed slightly the total market capitalization of the U.K. market! To emphasize this point, just the decline in market capitalization on the NYSE during October was almost equal to the total market capitalization of three major OECD countries and almost equal to the market cap in the U.K., which is the third largest stock market in the world.

(Exhibit 20) Much has been said about the institutionalization of the marketplace over time. This graph shows that from 1965 through the second quarter of 1987, individual holdings of equity (excluding mutual funds) have declined in relative importance from 84% to 62%. Meanwhile, institutional holdings have grown from 16% to 38% of direct ownership. However, individuals still own the major percentage of shares in the United States. This is of course different from trading activity, which is dominated by institutions who do the bulk of trading on the NYSE. If mutual funds were included, the numbers would change somewhat in that individual holdings would be somewhat higher and institutional holdings somewhat smaller in relative importance. Nevertheless, the main point here is that the underlying trend is toward further increases in the institutionalization of the marketplace.

(Exhibit 21) This exhibit provides some light on the October break in stock prices. Institutions were heavy net buyers of stock on the NYSE to the tune of 5.8 million shares daily during the first quarter. They turned to slight net sellers in the second quarter, but returned to a net buying pattern in the third quarter. However, their sentiment started to change in September as they became net sellers of about 300,000 shares daily. This selling pressure intensified sharply in October, when their net sales averaged 4.4 million shares per day on the NYSE. Given that the average price on the NYSE droppped to about $36 per share in October, this meant that institutional selling pressure was amounting to about $160 million daily during October.

In sharp contrast, the retail sector, including corporate repurchase programs, were heavy net buyers of stock during October. From a net selling posture in the first quarter, they became net buyers in the second quarter, net sellers in the third quarter, and were net buyers of 6.4 million shares daily during October. It is clear that the change in sentiment by institutional investors starting in September and accelerating in October played a major factor in the market crash of October.

Despite this grim picture, let's see if we can conclude on a brighter note.

Actually there are several points that we feel are encouraging and auger well for the future. First, we are not terribly pessimistic about the economic outlook. With some constructive steps in Washington, the coming year could prove quite a bit better than some of the doomsayers have predicted.

Second, despite our youthful appearance, we have been around for more than just a few market cycles. In our opinion, the firms in our industry have never responded more quickly to reduce costs than you have in the past six weeks. Painful as that process is, the prompt action on costs is a clear plus. By the same token, many of your firms are vigorously addressing the retail slowdown. That too, is a plus.

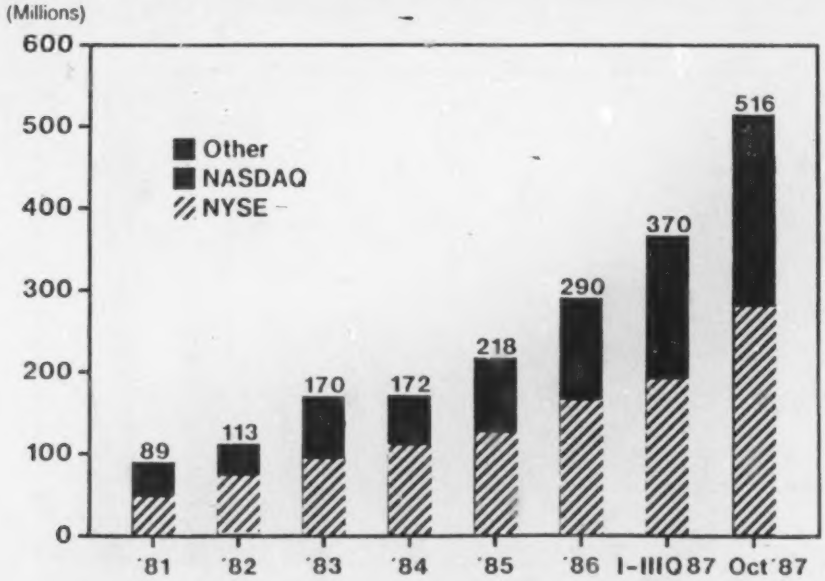
Third, as noted earlier, despite the deterioration in both margins and ROE, our industry throughout the 1980s has been among the most profitable segments of U.S. business and industry.

And last, there is a great deal of strategic analysis and decision making going on throughout our industry. It seems to us that when you combine strategic reappraisal with the impressive creativity and flexibility that has long characterized the people in our business, good things will result. We not only hope but believe that will be the case in the period ahead.

Adrian L. Banky	Jeffrey M. Schaefer
Executive Vice President and General Manager	Senior Vice President and Director of Research

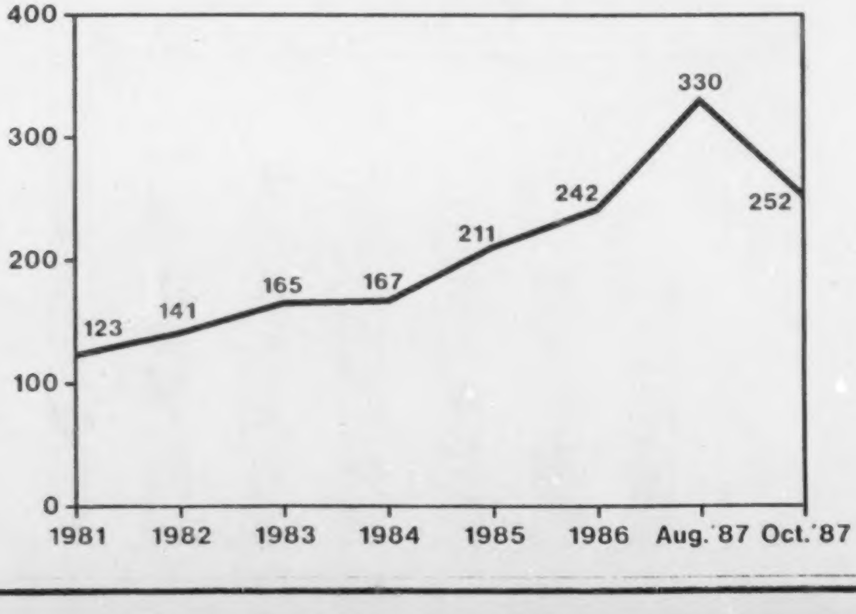
1

Growth in Average Daily Share Volume



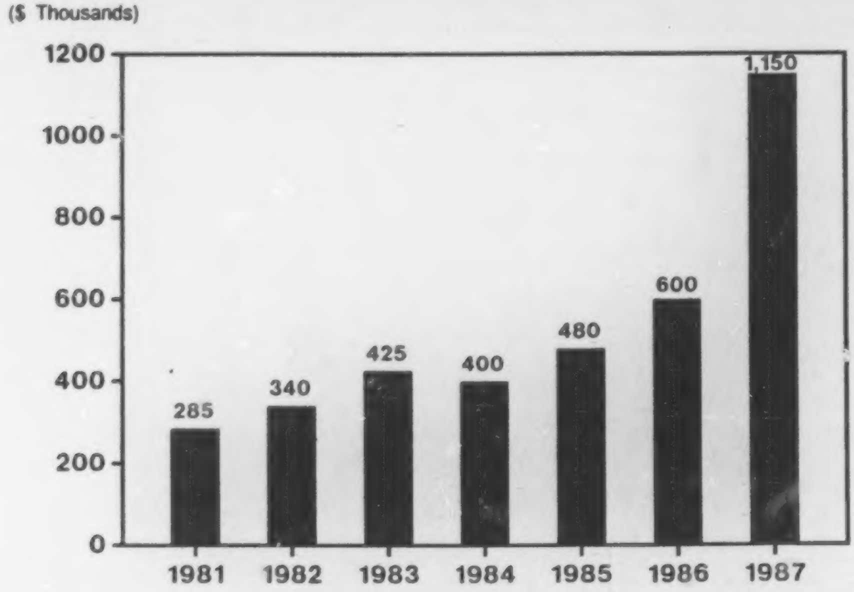
2

S&P 500



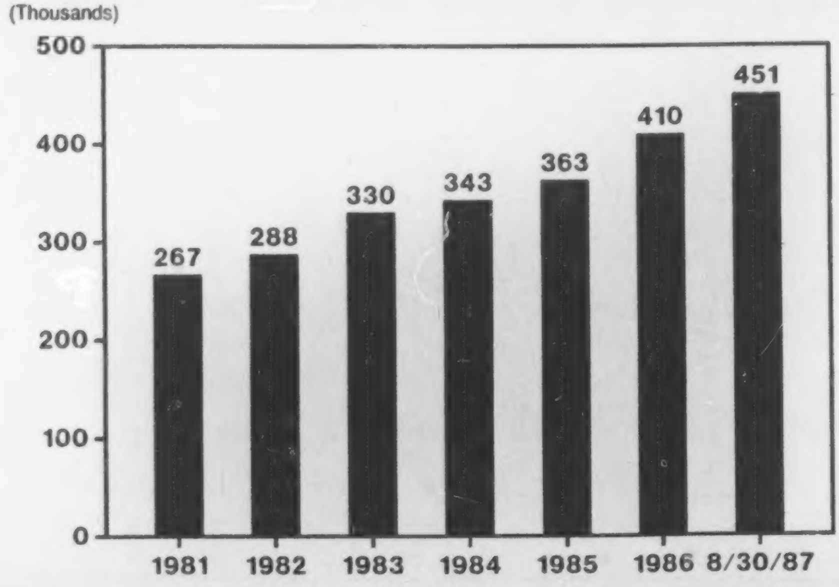
3

The Price of Membership on the NYSE in 1987 Was Nearly Double 1986's Record



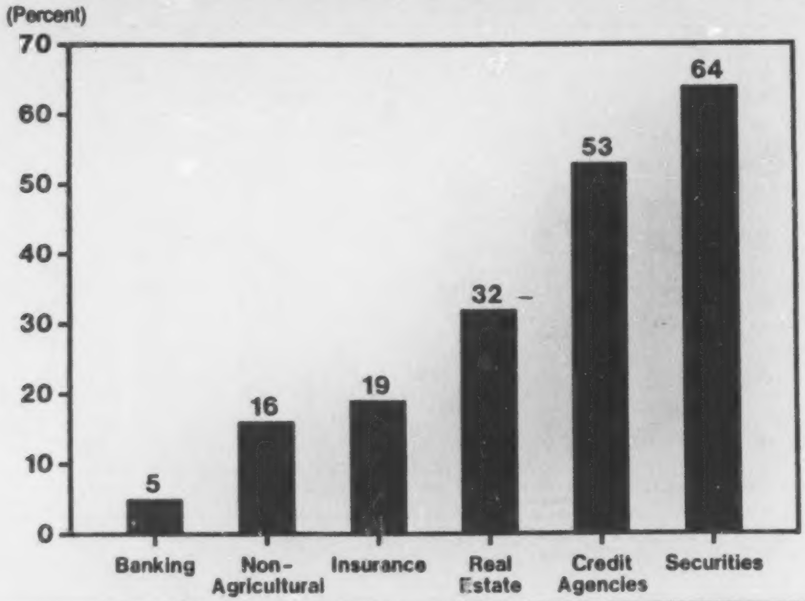
4

Growth in Securities Industry Personnel



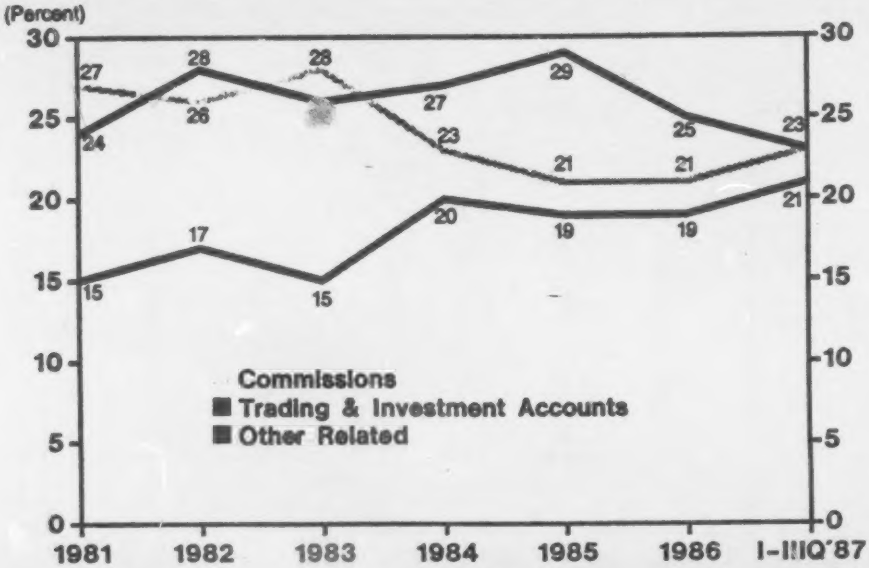
5

Growth in the Financial Services Sector Employment, 9/82 - 9/87



6

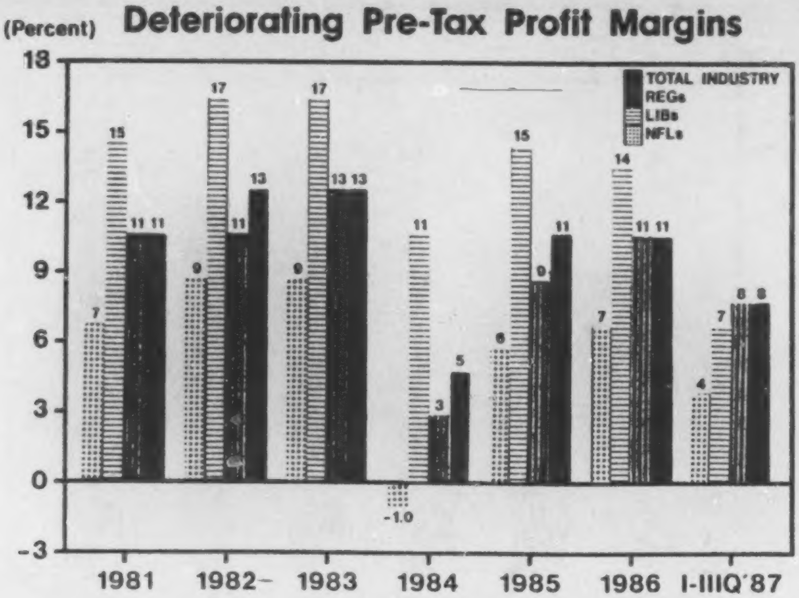
Main Components of Securities Industry Revenues



7

Whither Securities Industry Profitability?

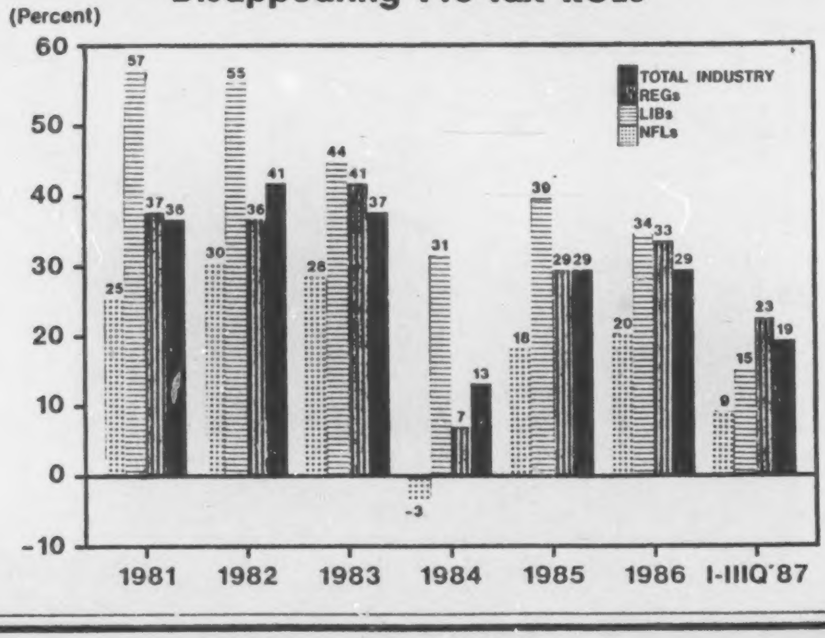
Deteriorating Pre-Tax Profit Margins



8

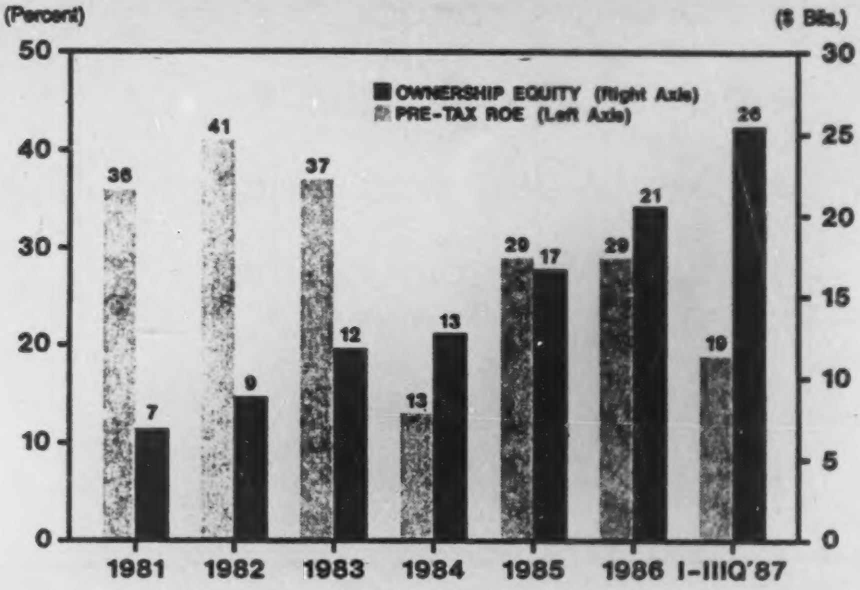
Whither Securities Industry Profitability?

Disappearing Pre-Tax ROEs



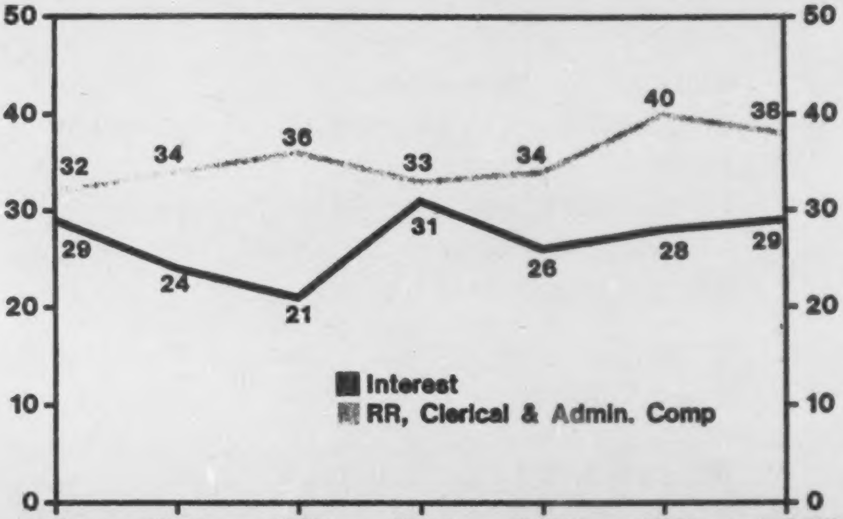
9

Ownership Equity Grows While Profitability Deteriorates



10

Main Components of Securities Industry Expenses



11

Cost Cutting Postures at 15 Randomly Selected Firms

4	No Real Change
4	Some Selective Cuts
3	Fairly Widespread, Significant Cuts
4	Major, Widespread Cuts

12

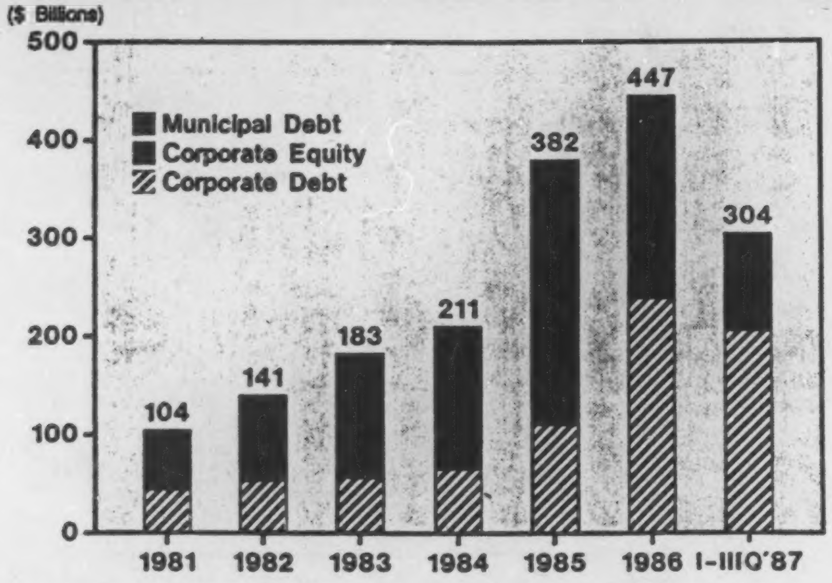
Types of Cost Reductions

Manpower
- Layoffs
- Attrition Not Replaced
- Freeze on New Hires
- Freeze/New Controls on Salary Increases
- Bonus Changes
- Sales Compensation Re-Analyses
- Termination of Low End RRs
- Ban/Controls on Overtime

Other
- T&E Controls
- Publications
- Quote Machines/Communications
- New Purchases

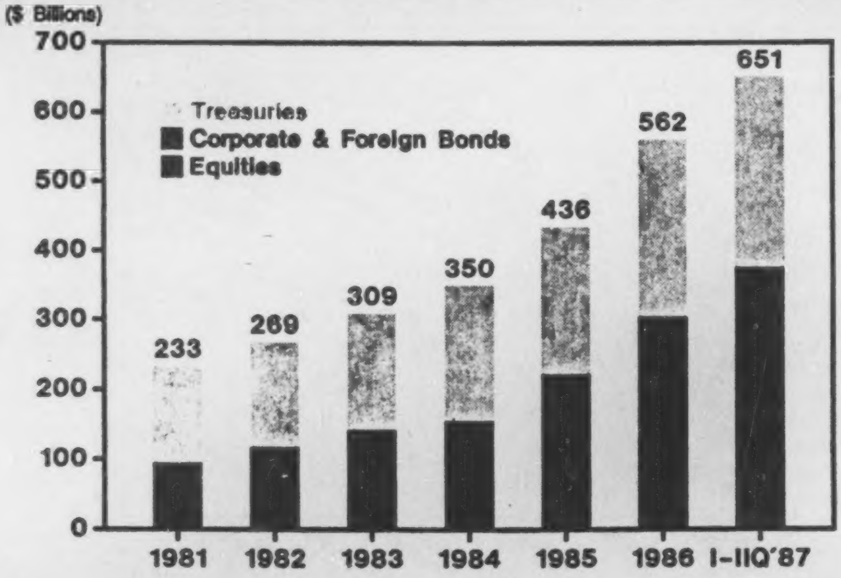
13

Corporate and Municipal Financing



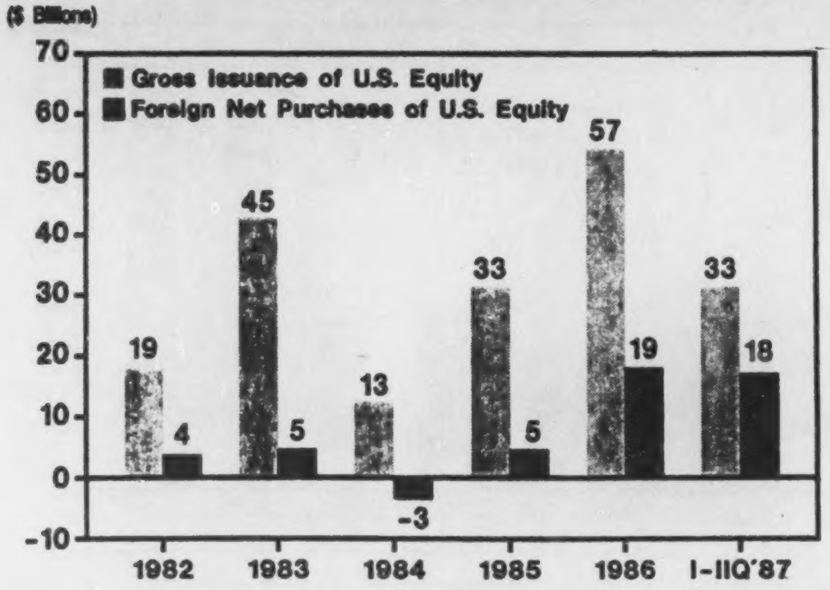
14

Foreign Investor Holdings of U.S. Securities



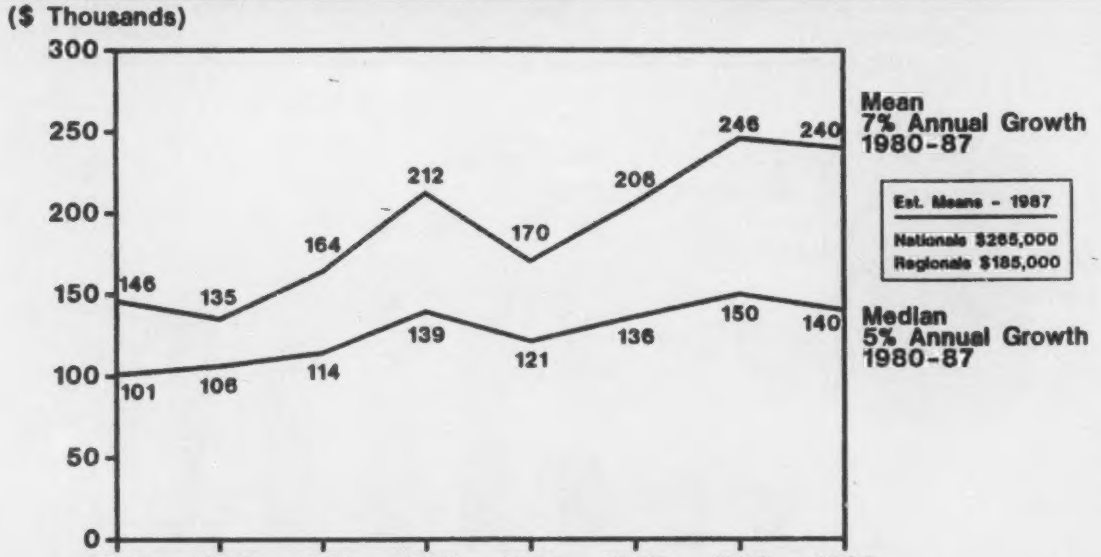
15

Foreign Investors Make Their Presence Felt in the U.S. Equity Markets



16

Gross Production -- Retail RRs



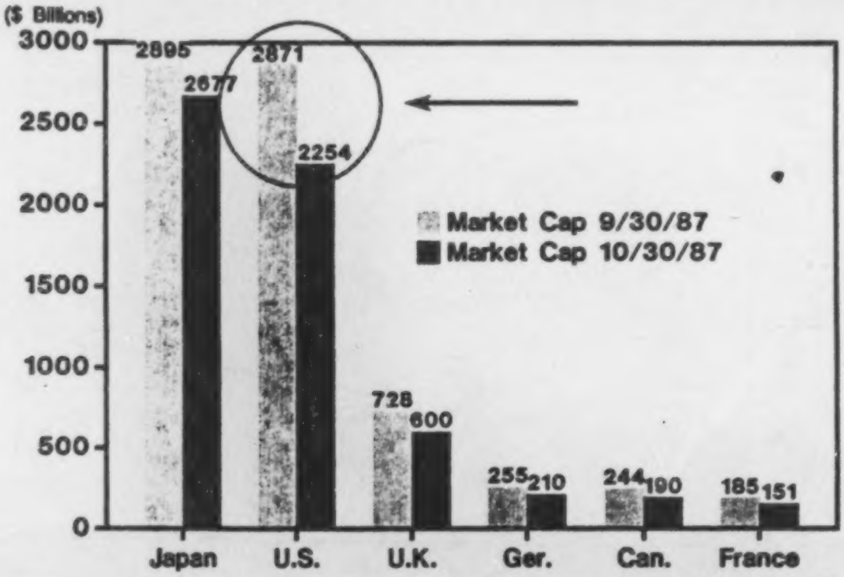
17

Steps to Stimulate Retail Sales Forces

- Call Every Account
- Call Accounts Near Margin Calls
- Encourage Tax Switches
- Tell RRs Production Needed for Payout Bonuses 1987
- Promote Use of Investment Managers
- Daily Sales Ideas for Newer RRs
- New Ad and Sales Promotion Campaigns
- Counseling RRs on Personal Financial Problems
- New Account Contests

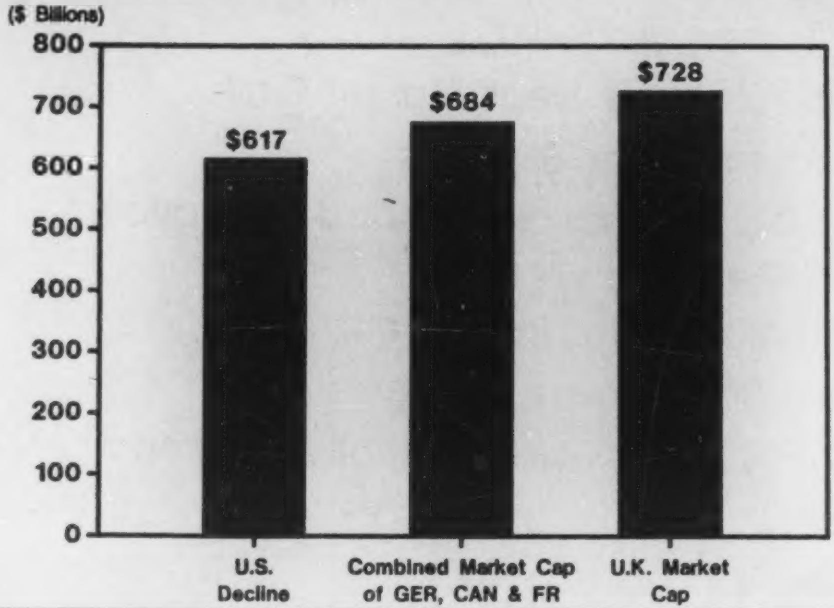
18

Market Capitalization of Major Exchanges



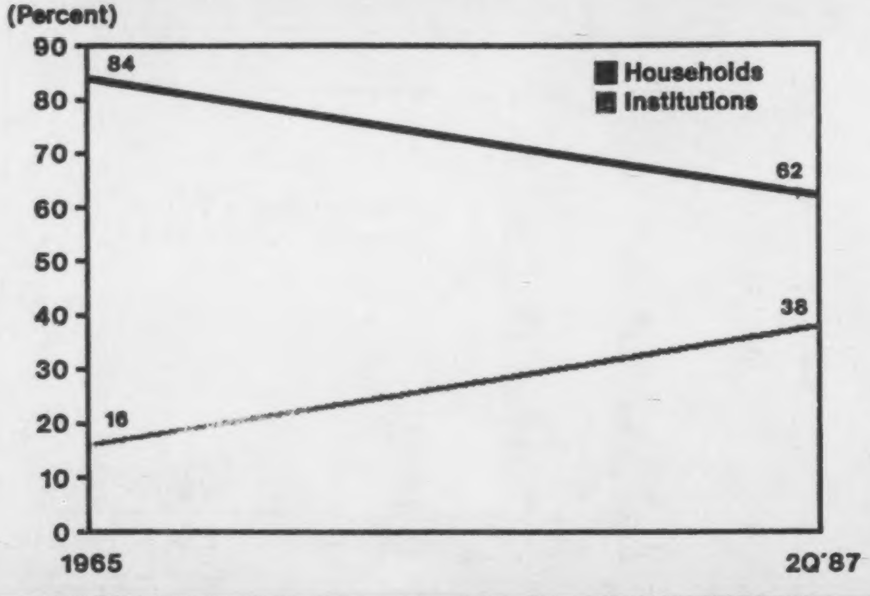
19

The October Decline in Perspective



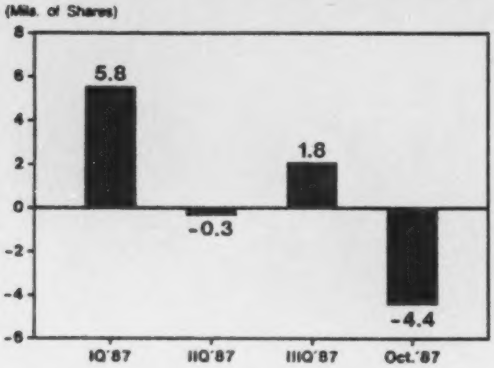
20

Direct Holdings of Equities



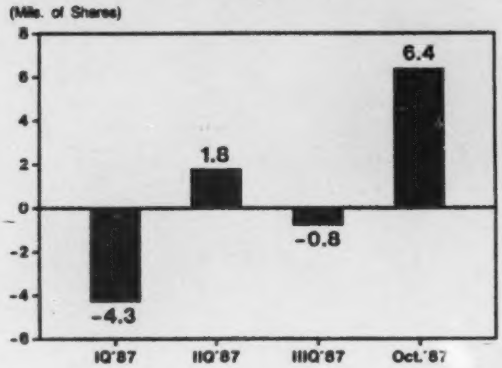
Professional Institutions

NYSE Average Daily Net Purchases



Retail Investors

NYSE Average Daily Net Purchases



Securities Industry
Trends

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AN ANALYSIS OF EMERGING TRENDS IN THE SECURITIES INDUSTRY
Produced by the SIA Research Department

3/4/88 A8825-1

Vol. XIV, No. 1 February 22, 1988

THE CHALLENGE OF SECURITIES FIRM MANAGEMENT TODAY

A Summary of Presentations at the 1988 Trends Conference*

The theme of the 1988 Trends Conference was "The Challenge of Securities Firm Management Today." The day's conference featured various senior brokerage industry executives addressing the overall challenges and problems of management within the securities industry and the peculiar nature of management in this industry. Topics ranged from managing your business in down markets to using technology and capital to improve profitability.

The keynote address from Primerica covered, "Financial Services Synergy: Reality or Illusion?" In addition, highlights of the joint Securities Industry Association - Arthur Andersen & Co. study entitled, "Wall Street's Workforce - an Analysis of Productivity and Personnel," were presented.**

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* The full transcript of the 1988 Trends Conference is available for $50. An order form is attached.

** Those interested in receiving more information regarding the Workforce Study may complete and return the attached order form.

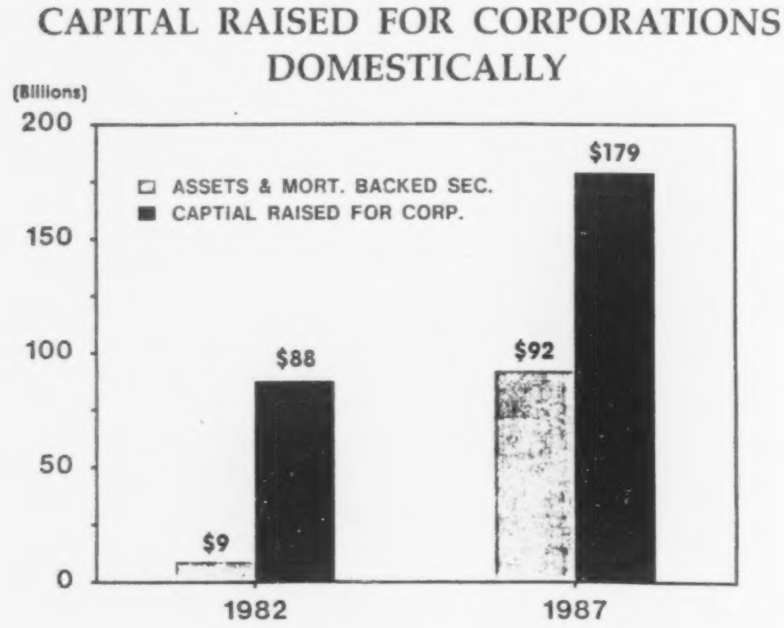
INTRODUCTION

EDWARD I. O'BRIEN
PRESIDENT
SECURITIES INDUSTRY ASSOCIATION

While this has been a very trying year for the industry, the world should never be looked at in a vacuum. The past five years have been a time of tremendous growth and profitability for the securities industry. Many of the challenges we are facing today are a result of the rapid expansion of business which burst upon us from 1982 to 1987.

Despite the problems of 1987, the year still saw some major contributions from the securities industry.

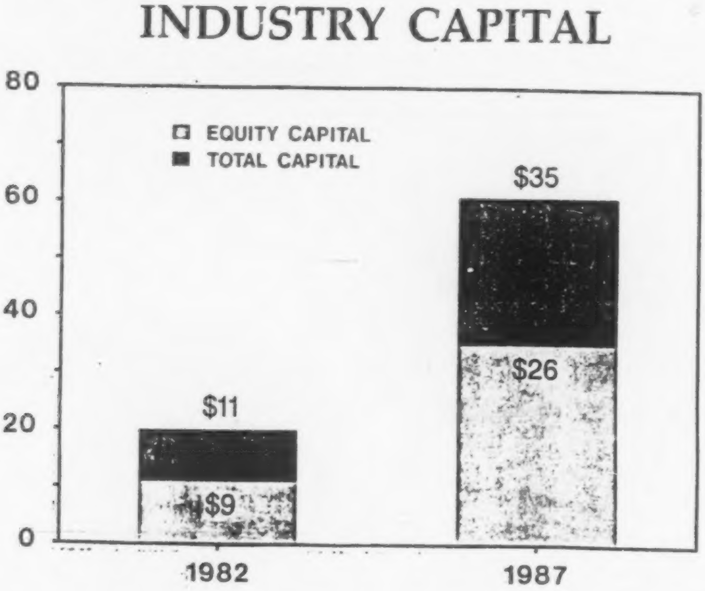
TABLE 1



As you can see (Table 1), capital raised for corporations through domestic underwritings in 1987 totaled $179 billion, double the level of $88 billion five years ago and second only to 1986's record of $218 billion. These underwritings exclude mortgage and asset-backed securities which totaled a record $92 billion last year, more than a ten-fold increase over the $9 billion raised just five years ago.

Over the past five years, industry capital has more than tripled rising from $11 billion at the end of 1982 to $35 billion last year (Table 2). Similarly, over the same period equity capital tripled, rising to $26 billion from $9 billion.

TABLE 2

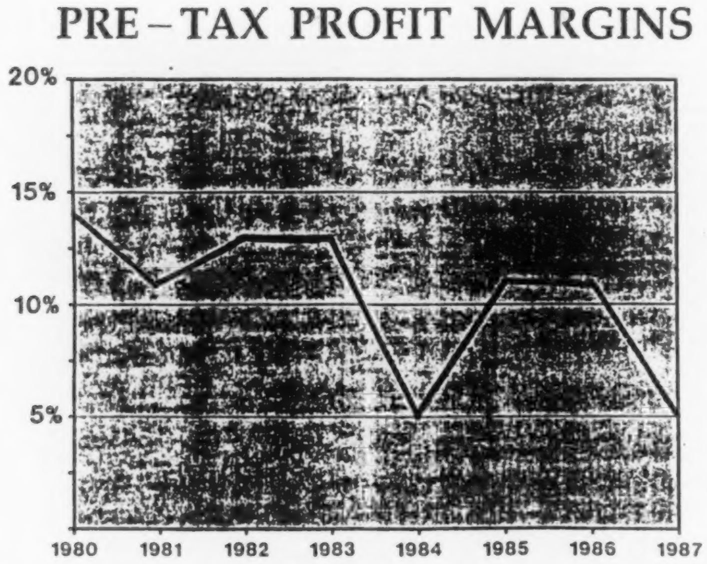

INDUSTRY CAPITAL

Losses sustained in the fourth quarter of 1987, projected to be around $800 million before taxes, dragged down the annual showing. At the end of the third quarter, the industry had an 18.6% pre-tax return on equity. The fourth quarter loss was the first quarterly loss by the industry in three and one-half years. The industry last posted a pre-tax loss in the second quarter of 1984, although the $100 million loss then pales next to the projected $800 million loss.

What is more alarming, however, is even in the good years of 1985 and 1986, return on equity hovered below 30% compared to 50% in 1980.

We see a similar deterioration in profit margins (Table 3). In 1980, 1982 and 1983, pre-tax margins were in the 13% to 14% range. In 1984, this fell to 5% and only returned to 11% during 1985 and 1986. Last year's poor showing fell back to around 5%.

TABLE 3



One of the areas where firms are making adjustments is in employment. This is a situation of concern to all of us. There are numerous job losses affecting our industry. This type of contraction is a painful process; certainly for the individuals affected, but also for those, probably some of you in this audience, who have to make and then implement these decisions. These are, after all, not just statistics or news stories, but friends, colleagues and co-workers. Lay-offs affect many lives.

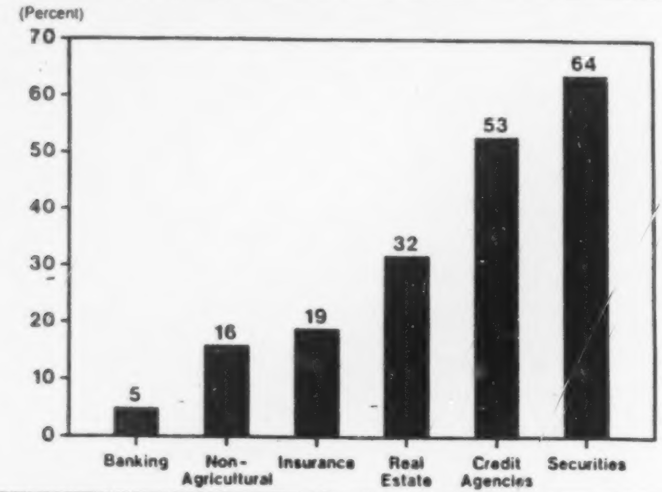
It might be helpful to put things in perspective.

This industry and all businesses have gone through other periods of contraction and have always bounced back. Employment in the industry has grown dramatically over the past five years. Employers of just SIA member firms have added 100,000 jobs since 1982, a 50% increase from 200,000 in 1982 to about 300,000 last year.

Statistics from the U.S. Department of Labor show an even higher growth rate for total securities industry personnel: 64% or over 160,000 new jobs created in the industry since 1982. In comparison, bank employment in the same five-year period had a 5% growth rate, while the insurance industry grew at 19% and real estate at 32% (Table 4).

TABLE 4

Growth in the Financial Services Sector Employment, 9/82 - 9/87



It is likely that some of the staffings in this industry were carried out too aggressively and now that the bull market has ended, abated, or at least taken a major correction, firms are adjusting to more modest staffing levels. At any rate, these moves have been swift, if not brutal, but they may now place securities firms in a better position for the periods ahead by lowering expenses.

THE CHALLENGE OF SECURITIES FIRM MANAGEMENT TODAY

JOHN S. CHALSTY
PRESIDENT
DONALDSON, LUFKIN & JENRETTE SECURITIES CORP.

When I joined DLJ in late 1969, I was appalled by what I perceived to be a lack of attention to the management process in the securities industry. I told people that the securities industry as far as I could tell was not a business at all, but in fact, a sort of cottage industry with various fiefdoms going their own separate ways. It was only later that I came to realize, with considerably more humility, that I was comparing a structured formal management process that I had become familiar with at Exxon, with an operating style that had served this industry very well for the decades after the war, the classic partnership that is still practiced in many law firms and many other financial services firms.

In corporate America, management is an honorable and desired profession. The young would-be executive aspires to and starts training to be a manager on day one. Management is his or her goal, and a very honorable one too. The best manager gets the most out of the organization and eventually gets to be the boss. There's nothing wrong with that. In fact, that's the way the system should work. And that's because in most of industrial America, no individual by himself or no small group by itself can dramatically impact the fortunes of the company, for good or bad.

It's also inconceivable in most industrial American corporations for any employee to earn more than the person that he or she normally reports to. Now, compare that with the classic securities partnership of the 50s and 60s. Compensation was related to personal performance. The best performers, whether they be traders or salesmen, became leaders. But they became leaders in the sense of player managers, not in the sense of the classic managers of corporate America.

In addition, through most of those 50s and 60s, there were a couple of distinguishing things about our business which I think made that form of management quite appropriate. First of all, it was essentially an agency business. Capital was generally not at risk. The individual could contribute significantly by his own efforts to the good fortunes of the firm without exposing the firm to major risk. One was unlikely to produce a financial disaster.

The 70s changed that a lot, mostly because of shrinking margins. The ability for firms to make money was greatly impaired by declining commissions and shrinking margins in the 70s. A contraction resulted in our industry as mergers and acquisitions took place. The management of a merged company was different from the management of one's own partnership. The need to seek out new products and new businesses appeared to be substantial, and frankly, for most of the 70s, Wall Street did not have the capabilities, nor did it aspire to have the capabilities, to manage in the environment of the 70s as that evolved.

The 80s brought its' own set of changes. First of all, a very substantial increase in capital risk, often associated with new products but mostly an increase in the capital at risk, occurred and that's had some major results. It has resulted, for example, in the damage that can be done to the P&L, if not to the firm, by a single trader or group of traders.

Secondly, the big buzzword is internationalization in the 80s. And that's really a very difficult thing for most of us to do. We've tended to be parochial firms. The problems have totally overwhelmed most of the experience that any of us had before. It's only been in the last few years that this has developed, and no one has really had experience in international events. Management hasn't yet understood the differences in culture and the differences in management style and the differences in control that are necessary in a European and Japanese environment.

New products have also been both an opportunity and a problem during these years. But most of all, the issue that has made this totally different than any experience any managers on Wall Street have had before is simply that of growth. This has become a totally different industry than it was 17 years ago or 18 years ago, or even just seven or eight years ago. We haven't built up a cadre of experience in the management of the very diversified, very different, very risky businesses that we are now involved in.

At DLJ, we emphasize three points in our planning approach: the process or determination of business strategy, capital commitment, and people. The result of a strategic planning process is not necessarily the important point -- the important point is the process itself. We spend a lot of time with a bottom-up approach involving the professionals in our various groups who come together and in the process of planning discover what they believe is the most likely set of circumstances for the firm in the year, and years ahead.

That very process helps in the understanding of those forces that act upon our business. Most important, it gives us all a sense of participation in the process, and a responsibility for the process, not only for its results but for the process itself. In fact, more for the process itself than for its results, because we recognize that the results are dependent upon exogenous factors that we certainly cannot control.

The final issue: every single chief executive on Wall Street speaks about the quality of his people. I get very annoyed when I hear our industry taken apart for greed or lack of ethics. I remind my friends in corporate America that there is no business that I know of anywhere, where individual standards of ethics and behavior are as high as in our industry. They have to be. If you think of the fact that every day transactions in the billions of dollars take place over the phone, between two people who have never met, and honor those transactions, were there just a tiny fraction of 1% of dishonesty in that process, the industry would stop working, stop functioning.

Finally, one issue that I'm concerned about and which I'm sure that everyone else who has a management responsibility on Wall Street is or should be concerned about, is that the management of growth gets particularly tough when the growth stops. And that may be where we are right now. I think that's going to be the real challenge over the next couple of years. Hopefully, the slowing in growth is only temporary, but that's the most difficult thing that faces us.

THE CHALLENGE OF SECURITIES FIRM MANAGEMENT TODAY

ROBERT F. SHAPIRO
PRESIDENT
RFS & ASSOCIATES, INC.

An important part of management's role, I believe, is the necessity for trying to read the tea leaves. Clearly at a point in time such as the one in which we are now, that is a very difficult challenge. Nevertheless, I don't think management can be responsible for, or be effective at, establishing policy and direction without some expectations for what the future will bring.

A firm must also have a mission. No organization can be all things to all people. Clearly, whatever activities a firm engages in, it must strive and believe it can be, among the best, where competition will not allow it to be less and still survive profitably.

There are two areas of activity which are fundamental to the very existence of this industry. Namely, the generation of investment ideas and the execution of these ideas via the relevant market. No firm can effectively service its clients without these abilities. During difficult economic times, firms must maintain their strength in this regard, even if it means incurring departmental losses for some period of time, albeit in manageable proportions. Clearly, therefore, firms must define their mission, constantly challenge the premises supporting it, and always be flexible and willing to change.

What, then, about the day to day? There are several categories of focus which I believe essential to any well-managed firm. Specifically, I shall comment on the following: personnel motivation and supervision, capital management, and the need for a culture.

What is essential in developing the environment that is necessary to properly motivate and develop a response amongst individuals in an organization is incentive plans and particularly those which ascend as productivity increases. This industry thrives on incentive, and I believe incentive formulas should always be utilized whenever possible.

Supervision. I think of supervision on two fronts: one being management's awareness of an individual's performance in meeting the profit goals established and the other having to do with compliance issues. I have always found in my experience that periodic reviews of business plans and their execution are essential. One positive result is that this constant reassessment by management naturally results in a continuing review of the qualitative performance of all personnel, thereby enabling management to alert those whose work was not satisfactory. Whenever possible, I think it is management's obligation and responsibility to alert its people with whom it is not satisfied, and most particularly why.

Events of the last several years have made it clear that no organization can have too effective a compliance regimen. It goes without saying that programs for monitoring and control are essential. But equally clearly, they are not the answers of and by themselves. An astute compliance department activity is essential to enabling management to do its job. But this is only the beginning. Departmental managers and senior management must be actively involved on a daily basis in perusing the regular reports devised and deemed necessary by it and the compliance group.

It is clear that any stable investment firm can only be so by virtue of an adequate capital base. Constant attention must always be paid to the various regulatory ratios so that a healthy leeway exists to be able to function flexibly. At the same time, this must blend with an appropriate return on investment and a strategy directed to accomplishing the same. On an everyday basis, it is a must that truly efficient and cost-effective financial controls exist.

Specifically, all trading activities should, in my view, have precise limits which should never be permitted to be exceeded without specific senior management approval. I also believe that certain aging criteria exist for all positions, and once a position becomes stale, it must be liquidated. In this regard, I think a short time frame is clearly healthiest and for me, anything beyond five trading days becomes a real exception, and with today's volatility, maybe this is too lenient. I cannot stress too strongly how important these issues are for any firm's fuel is both its capital base and how it is utilized.

The need for a culture. I have purposely reserved this area of comment for last, as I believe this to be paramount to any firm's long-term success. Effective management of a securities firm must communicate to its people an awareness of the important aspects and issues of every sector of the business; a basic sense of fairness and consistency in dealing with all personnel; a compassion for individuals and particularly when they have personal problems, and a high standard of values and ethical conduct. And the manner in which this materializes is a function of the effectiveness, and to some extent the frequency, with which an active dialogue transpires between individuals with management responsibility and those for whom they are responsible.

THE CHALLENGE OF SECURITIES FIRM MANAGEMENT TODAY

DONALD E. WESTON
CHAIRMAN
GRADISON & CO. INC.

I shall make ten key points that we believe are of paramount importance to the health and prosperity of a regional or local firm with diversified product and service capabilities.

1. Implement corporate mission -- offer the highest quality service, products and advice, with emphasis on those which are proprietary, while at the same time optimizing the shareholders' return on equity and operating within the spirit, as well as the letter, of the rules and regulations governing our business. Identify specific market or markets and concentrate firm resources: people, capital, proprietary products, and proprietary services.

2. Commit to a market vs. product driven philosophy. Maintain an ongoing market research to determine changing needs.

3. Differentiate yourself from your competition, such as with proprietary products and services, highest quality service and superior performance.

4. Develop a strong marketing plan to maintain and build market penetration.

5. Leverage small size/flexibility -- take advantage of size by moving quickly to fill niches created by changes.

6. Measure risk vs. potential reward while jealously guarding your capital base -- only commit capital where the potential reward is large enough to make a major difference in earnings.

7. Acquire or merge with others that bring desired capabilities or additional volume which would otherwise be more costly or impossible to build internally.

8. Create an environment to attract and retain key professionals by using: compensation tied to profitability at all levels of the organization; fringe benefit and retirement programs to encourage key management and producers to make a career with your firm; a computer operation/systems approach, and new offices with a positive environment.

9. Manage costs -- review each segment of business to determine profitability and eliminate those functions or products that are losers if they do not impact overall competitiveness. Over the past few years we have eliminated: corporate bond underwriting, naked option writing and an auto leasing operation.

10. Structure your organization and business in such a way that you are attractive to others in the event that this strategy becomes the best interest of the shareholders.

To summarize, I believe these ten key points are very important to continued growth, profitability and survival in the extremely competitive environment which lies ahead.

WALL STREET'S WORKFORCE
AN ANALYSIS OF PRODUCTIVITY AND PERSONNEL

MARC H. STERNFELD
PARTNER
ARTHUR ANDERSEN & CO.

Headcount contributes to two-thirds of a firm's non-interest expense. This includes not only salaries, bonuses, fringes, but also the space, light, heat, power and technology expense required to support today's Wall Street employee.

The costs of support, however, are often obfuscated with arbitrary distinctions, since when the support reports directly to the trading and sales desk, their salaries are a direct cost. Yet, when they work for operations, they often become part of the much-maligned allocated costs. Consequently, to accurately analyze the workforce, we created several working models of securities firms. Using our advisory board, we validated the job titles we had and sent out the survey to the SIA membership.

The response of the membership was excellent: 112 firms or 22% of those solicited responded. Moreover, 17 of the 20 largest firms responded, giving us a sample representing three-quarters of the workforce of the SIA membership or over 220,000 employees!

Of the total employees in the survey, 65% worked for the National Full Line firms (NFLs) and 16% for the Large Investment Banks (LIBs). If you include an estimate of those that did not respond to the survey, you conclude that two out of three of the industry's workforce work for one of the 20 LIBs or NFLs.

Looking at the workforce growth during the Eighties in terms of several factors, the industry has grown at the same pace. The workforce has grown about as much as offices and accounts in percentage terms. Meanwhile, the revenue growth in this period has outpaced the headcount growth by double, and profits have outpaced the workforce growth by 25%.

The stock market collapse of October and the acquisition of E.F. Hutton both have had an impact on the workforce. Although much has been written about the growing layoffs in the industry, in the last six months of the year the workforce has been reduced by less than 10% or less than the number of people that were added between January and June of 1987. So once again, 1987 will be a year where the industry's headcount will end larger than when it began.

What does the market collapse of October say about workforce levels? The crash is not as much a factor on the workforce as the impact the crash could have on the volume of business. The level of the workforce is related to the volume of activity and more importantly, the speed of the increase. If the impact of the crash flows through in terms of lower volumes, the number of people needed to handle that volume will be less.

Eight years of growth in headcount, revenues and profits have brought us to an industry of some 300,000 people. What do they do? Who works on Wall Street? In order to deal with the level of the workforce and with the issue of productivity, you have to deal with the majority of personnel. By focusing on the workforce, we focus on the dominating factor in the cost structure. But let's not forget that the workforce is also the dominating factor on the revenue side, and the contribution of individuals is obviously the other side of the analysis. Since so much focus is placed on understanding revenues, we're just trying to put balance into the analysis.

The most prevalent occupation on Wall Street is the retail salesperson. One out of four employees in the industry is a retail salesperson. What information can a firm provide to the broker to make him more productive, to help him sell more and different products to the customer base? The industry must increase its focus on marketing and applying techniques used by consumer product companies to better focus the sales effort, and to better differentiate between the productive and unproductive retail brokers.

Operations: those who clear and settle trades comprise almost 20% of the workforce. Traditionally, the industry has applied technology to make these people more productive. Yet, in many clients, we see that if you compare the cost, technology and labor of clearing and settling a trade over the past years, you will find that it has increased. As technology has made the individual operations person more productive, the mix of products has changed, where more and more of the industry's transactions are in products where automation has not fully taken hold.

The third most prevalent occupation is the retail sales support force. In this category lies 13% of the workforce. This category of support highlights different issues that firms must address. What is the function of these people? Are they making the retail salesperson more productive?

Our next category is secretaries and clerical, although this is primarily secretaries. One out of eight people in the workforce is in this category. Are secretaries managed by a professional in an organization, as is true in many other large institutions, or are you delegating this responsibility to the secretary's individual boss?

Finally, technology. Systems and communications represent six percent of the employees in the industry. When you add the equipment and service costs to the large personnel expense, the issues are: are you getting the most out of your technology dollar? Who controls that expense in your firm, and how can that expenditure be brought more into line to the business needs of the firm?

In summary, these top five occupations comprise 75% of the jobs in the industry, and if you're going to deal with the issue of productivity of the workforce, you have to deal with these five occupations.

Let's look at the ratio of support personnel to producer personnel. How many support personnel are needed to support the production force as one component of profitability? The ratio of support to producer workforce can be broken into three major component pieces: the ratio of support to producer workforce in the sales and trading business, the ratio of support to producer workforce in the fee-based business, and the ratio to firm support -- personnel, legal, finance, to the entire firm. The ratios of support to producer vary among the firms, from the highest level in the LIBs of more than 2-1/2 to 1, to the Regional/New York City-based regional firms with a ratio of 1-1/4 to 1. Given the high profitability of the LIBs, we see that a high ratio is not necessarily negative, but just one factor of understanding the firms in the industry's profitability. Interestingly enough, even in the small firms there are still more support personnel than there are producing personnel.

Among the general support categories -- personnel, finance, human resources, etc. -- we found that most of the categories among the firm groups are about the same, except for finance, that is internal finance -- accounting, control and reporting. Here we see that the relative number of finance professionals in the LIBs is much higher than in any other types of firms. We see that among the Regionals/New York City-based regionals, there is almost an inverse relation to the relative sizes of the finance staffs, showing that just being in the business probably requires a fixed level of finance function. However, the large sales and trading component in the Large Investment Banks and their worldwide presence have driven them to greatly expand their finance function.

Looking at the support to producer ratio, we bring together all support, whether it resides in the traditional support areas -- finance, operations and technology -- or directly in the producing areas. We found that one-third of the support personnel report to the producing departments. Therefore, whatever size you think your back office is, increase it by 50% to get the true cost of support for your firm.

FINANCIAL SERVICES SYNERGY: REALITY OR ILLUSION?

WALTER A. SCOTT
PRESIDENT
ASSOCIATED MADISON COMPANIES

Primerica entered the financial services industry out of carefully considered choice. Back in the late 70s and early 80s -- a period of extremely high inflation -- American Can, as we were then known, found itself in two primary industries: packaging and paper. Both of them were: capital intensive, growing slowly, and worst of all, experiencing severe margin pressure.

At that point, the corporation decided it would diversify into less capital intensive businesses with prospects of high profit margins and growth. One of the industries we identified was financial services. And indeed, in 1982 American Can definitely made the choice to enter that industry with the acquisition of Associated Madison.

We were attracted to financial services because it was an industry that had the characteristics we wanted: above average growth potential and opportunities for greater than average profits. One of our other major considerations was that financial services -- unlike many industries -- was not dominated by massive entities.

It is my opinion that in financial services, the key to success is distribution. If you find the companies that have better distribution systems or capability, and are low-cost providers of services, then it's easier to gain market share and see your profits grow faster than your competitors.

Since 1982, Primerica has acquired a significant number of services businesses. We had five insurance companies, then we entered the mutual fund and asset management fields, after that, mortgage banking, and, most recently, securities brokerage and investment banking.

In our evaluation of potential acquisitions we focus on the distribution capabilities, market niche, market growth potential and a company's competitive position.

We felt that by acquiring niche players in insurance and then in other complementary financial services, we could create value over and above what would exist if those companies operated totally separately by moving these complementary products through the insurance companies' distribution systems.

But do synergies actually take place? Are synergies real or illusory?

I think the answer is that synergies can be very real. But if a parent company tries to force them, they can quickly become illusory or unprofitable or both.

At Primerica, we have a group of highly entrepreneurial subsidiaries, affiliates and partners. We wouldn't have it any other way. They operate in tough, competitive businesses. In insurance, for example, our companies are sometimes competing against each other directly. They naturally want to do better in their respective markets than their sister companies do in theirs. So there is a healthy distrust among competitors.

The million dollar question is: how does the parent neutralize the resistance to synergies among subsidiaries? What is the parent's role?

The first thing is to realize is that to be successful the parent cannot dictate synergy. It would be like trying to force a bud to bloom. It doesn't work. The drive for subsidiaries to share resources -- in order to create value over and above what would exist if those operations worked separately -- has to in the final analysis come from the subsidiaries themselves, not the parent.

Our experience has taught us that the parent company can only help create the right environment for synergies. We can identify areas where joint ventures or other kinds of arrangements would be mutually advantageous for the subsidiaries, and then make it easier for top managers of the subsidiaries to acquaint each other with their respective businesses.

The process by which we've helped synergies is rather informal. We have roughly semi-annual meetings of the CEOs of our operations. The meetings present a good opportunity for the people to meet and mingle and get to know each others' businesses. It is particularly useful for the new companies to expose their businesses to the sector's CEOs. It is also very useful for the existing subsidiaries to get to know the heads of the newly-acquired businesses because it is on this level where things happen if they're going to happen.

So far, most of our synergies have been marketing synergies. There are also operational synergies developing and a significant financial synergy. I want to emphasize that we have no intention of evolving into a centralized financial services operation with a single back office and common management since we have a minimal sector staff. We do not look to merge back office operations, as long as the independent operating units can achieve an acceptable rate of profit growth and their operating results are equal to or greater than the competition.

Synergies certainly have a slower incubation period than we thought! And part of the reason is that the relationships are a little like the difference between people's relationships with friends and with family. It has been said that we let our friends get away with a lot more than we'd ever let family members get away with. We say we choose our friends but we're stuck with our families! We get the hand we're dealt there. You tend to find more faults in your son-in-law than in your friends -- even if your friends have the same faults.

So I think the same psychology is at work in the process of synergies. But it does work itself out; reason does prevail in most cases. And subsidiaries do begin to appreciate the real virtues of their sister companies -- especially when it adds to their bottom line.

MANAGING YOUR BUSINESS IN DOWN MARKETS

BENJAMIN F. EDWARDS III
CHAIRMAN
A.G. EDWARDS & SONS, INC.

I guess the way to manage in a bear market is to have your act together in a bull market. By this I mean, you must know what business you're in, what market you serve, and what special niche or broad area as the case may be, you have targeted.

It was important for us at A.G. Edwards to know exactly what business we wanted to be in and how we wanted to pursue it. It was important for us to concentrate on it and on doing it well. We had to know what kind of firm we wanted to be and then unite to achieve that firm, that common purpose.

The goal of making a lot of money does not always unite people. In fact, it often sets them at each other's throats. So our goal should be to perform some function that serves the long-term interests of our market. We must be customer-oriented. The goal decided, it became a matter of how well we could perform together, how good a team we could be.

We ought to structure ourselves to achieve our purpose. For example, our compensation should be consistent with the corporate direction we've chosen. It's a crucial decision. In our case, it was teamwork vs. the star system. Everyone should have a self-interest in the bottom line. Everyone should be encouraged to put the customer first. Everyone should be encouraged to make decisions that will stand the test of time.

In our compensation system in the mid-60s, we had departmental overrides, we had a whole override system. We got rid of all overrides in the home office; those were not profit centers. Our profit centers were our branches, and the job of the people in the home office was to serve the ones in the field. It took about two years for people to believe us, but when they finally did, we wasted a lot less time and worked better because we could trust each other.

Adversity then, a bear market perhaps, becomes a common challenge which should draw us closer together rather than set us against each other. When things aren't going well, there is an almost irresistible urge to point fingers and blame someone other than ourselves. This must be fought.

The important thing is to rally together to work out solutions for the adversity. Cost-consciousness is a state of mind, an attitude of abhoring waste and furthering the common good. Some industry compensation practices would seem to do just the opposite. And I think here of examples -- one very sizable and notable firm recently spent millions and millions of dollars signing off with an executive. To me, that sends horrible signals to the rest of the organization.

I happen to be against paying bonuses for producers. I think that number one, you encourage people to make a move not for a career or professional reason; and two, you set yourself up for the person that comes along with a higher offer. You're vulnerable to that. And probably the most important reason is you give the signal to your own person that sits next to the one you've just gotten, you say, "you're a dummy. If you want 'X' thousands of dollars, you have to leave to get it."

Overrides -- I mentioned how debilitating they can be. An appeal to greed and not teamwork is something that is common in all the things I've just mentioned. Greed is a powerful motivator, but it can be a destructive one.

If structural or compensation changes must be made to meet the exigencies of a bear market, talk the alternatives over with those affected well in advance. Listen to their input and come up with an even-handed policy that can be at least understood, even if it is not liked.

As managers, we don't like to be surprised. Our people don't like to be either. Let's treat each other as we would want to be treated. Surviving a bear market or managing through one then becomes a matter of building a strong, open and trusting internal organization with the courage to adapt to changing conditions. Each of us should ask him or herself, "What am I doing that is making someone else's job more difficult? What can I do to help us be more effective, more efficient, or more productive? What can I do without -- not what can somebody else do without?"

My conclusion is that a healthy environment must be built within an organization, an environment encouraging teamwork and common purpose, and be in place if one is to manage successfully in a down market. All of your professionals will know what must be done. But your challenge is to get them to do it on their own.

USING TECHNOLOGY TO IMPROVE PROFITABILITY

LAWRENCE J. STUPSKI
PRESIDENT
CHARLES SCHWAB & CO., INC.

I was assigned the topic of "Using Technology to Improve Profitability" and I thought that considering the fact that industry expenditures in technology doubled in the last three years and are expected, in a pre-crash study, to triple by the end of the decade, I thought my topic was more a mutually exclusive contradiction, sort of an oxymoron.

Schwab is a company that is built around applied technology. It really is a data direct response marketing company and a data processing company. Everything that we do is built around our software and built around efficient processing. The "Wall Street Journal" last Friday articulated a number of the frustrations and the obstacles that we run up against using technology in the financial services business and we all have the deck stacked against us in this area: projects that come in 100% over budget, years late, 80% of your programming staff or your analytical staff working on maintenance, uneducated users, overeducated technicians, tremendous amount of frustration in the use of technology.

We have the deck stacked against us, and I think we have to try to move the odds perhaps a little bit in the other direction. And my antidote for moving the odds in the other direction is to stop wasting money

That's not a particularly insightful or brilliant statement, but I've picked three areas this afternoon to talk about that might be helpful.

The first one is to try to have a simple business objective or an over-arching philosophy toward any technology project that you attempt to implement. Believe me, the execution of the project will probably be very complicated. The chances are you will run into all of the frustrations that were outlined in the "Journal" article last Friday. It will be difficult; there will be delays. Things will fail, you will be late, you'll probably run over budget, you'll go crazy doing it -- so give yourself a little bit of an advantage and try to have a simple business idea, a simple philosophy that overrides the concept of your project, a clear business concept.

There's sort of a corollary to this rule which is, once you get the clear business objective, try to design the project and get it concluded while you still have the same brilliant conceptualizers and executioners working on it, because we all know that most of the idiotic things done in our companies were done by our predecessors. It's a constant rule. So if you wind up doing a project where you're going to have a number of series of managements in there, it's kind of doomed to failure, because each group is going to come in and sort of negate what the group before it did.

The second thing that we've learned that I wanted to share with you is to try to knock off or meet a number of business objectives with technology projects. Being natural optimists, we always either underestimate the costs of these projects or overestimate the benefits. So what I like to try to do is stack the deck in my favor by trying to design projects that meet a number of business objectives.

Two quick examples. One is what we call our lead system, which we developed two years ago. This is a system that follows an ad from the time it's in our in-house advertising agency until the time it gets placed in the media. From this we can tell you what the cost is of a full-page on "Barron's" page six, and whether the mix of business that we get from that page is all equities or equities and options or big traders or small traders or whatever. It feeds a fantastically important system that is extremely efficient at monitoring and making constantly better our cost of acquiring new business. This system also basically runs our mailroom. Our whole outgoing mail operation is automated from this system, and it has a lot of modeling techniques. You can say, what if you did this to your price schedule, and overnight we could say what it does to the average ticket, what it does to the gross, which customers pay the most for it, which customers pay the least for it. This is a fantastic development all because we took the time to meet a number of business objectives by one technology project.

A bad example -- a missed opportunity, not a big screw-up -- was last year: a group from our branches identified a new customer ledger screen that would be used to respond to customer inquiries out in the field and they neglected to understand how the customer ledger screen was used in the back office for different functions. So when it came time to cut-over, what we wound up was two customer ledger screens instead of one, because the branch-oriented project didn't include the objectives of making the back office work simpler. Again, a missed opportunity. It probably wouldn't have taken much more than an extra week or two to include those specifications in the design.

Talking about wasting money and spending money, my third point is to try to pay attention to demand projections and manage your physical plant or your data processing plant or your expenditures accordingly. Although obviously you can't predict the market, I know exactly how much business we're going to do in 1988. We're going to do the amount of business that's dictated by the formula -- take the number of customers we have, add the number of customers we'll add this year, multiply it times the amount of money they have, times their inclination to trade in the market, times the convenience or accessibility that they can get to our firm.

Of course, people look at me and say, "that guy is a wise guy -- any dope knows that!" But the point is that the values in each one of those variables is not zero to infinity. The values that you can ascribe on those, in that formula, is something you can narrow down -- you can box the range. And once you begin to do that, clearly, the objective is to have enough capacity so that you can make some money and respond to customer demand in periods of high demand without going out of operational control and yet not carry so much expensive excess or idle capacity in times of slack demand, that you hurt yourself too badly financially.

The late British historian and author, Arthur Clarke, once said that "any sufficiently developed technology is indistinguishable from magic." Using technology in the securities business often seems like magic to us, but indeed, it is not magic. It is the hard-headed application of rules or principles like the three I talked about today, and a number of others, that will try to get us to the point where we perhaps stop wasting some of the money that we're wasting and get technology working toward the profitability of the firm.

USING CAPITAL TO IMPROVE PROFITABILITY

JAMES T. BARTON
PRESIDENT
PRUDENTIAL-BACHE SECURITIES INC.

It's my understanding that Jeff Schaefer picked the topics for this conference some time before October 19. Post-Crash, he may wish he'd renamed this discussion, "Finding Profits to Preserve Capital!"

Let's look at two periods during this decade. The first would include the years 1980-83. Purposely excluding the 1984 debacle, the second would include 1985, 1986 and the first three quarters of 1987. Of course, fourth quarter figures would undoubtedly bolster my argument.

During the 80-83 period, the securities industry as a whole enjoyed average after-tax ROEs ranging from 19% to 27%. However, beginning with 1985, the numbers were 16%, 15% and 10%. Thus, even before October 19, the post-84 boom did not come close to the pre-84 period in terms of equity returns.

One of the most interesting details to come out of this analysis is the deterioration in the profitability of large investment banks. From a peak ROE of 30%-plus in 1981, their average ROE had plunged by June of last year to less than 10%. The line graph for the segment looks more like a cascading waterfall than an Alpine landscape. What makes that so interesting is that many of us have looked to investment banking as a source of new and ever larger profits.

Of course, we could look at the high ROEs of the early 1980s as an historical aberration. In the late 70s, for example, the highest the industry average ever got was 17.6%. For the same period, large investment banks saw year average ROEs no higher than 22%; and, in fact, they fell as low as 8% in 1977-78.

What is more, as many firms have expanded in recent years they have rapidly built up their equity capital through retained earnings and investments -- so much so that earnings may not have grown as fast as capital has.

Yet that possible explanation only leads us back to the original question. That is, what kind of returns will invested capital command in the future? Could even higher profitability be in store? Or might we be throwing good money after bad on the basis of out-dated expectations?

With many of us already responsible to public shareholders or private parents, the pressure to generate higher ROEs has intensified. One way to attempt to do that is to leverage our balance sheets, which, of course, increases risk.

Second, we could bring costs, especially compensation, back to earthly levels -- and, for once, keep them there. From the looks of it, this now seems to be the most commonplace, if not the most universally popular, way to battle revenue stagnation. Draconian cost-cutting measures today, however, may undermine a firm's efforts to seize opportunities tomorrow.

A third option is to pursue a niche strategy. A lot of firms have decided to focus on a particular specialty, like merchant banking or asset management, rather than being all things to all people. The risk of this strategy is that this year's profit opportunity can become a loser next year.

Indeed, none of these approaches is the single answer. Any strategy must recognize that, in today's increasingly complex global marketplace, substantial capital will be required.

As firms searched for ways to wield a competitive edge, to preserve fees, to enhance profits, they've put their capital -- and reputation -- more and more at risk. The first stage was the bought deal -- to secure an underwriting the firm dedicated its capital to buying entire issues. The next stage came from the M&A department. To secure takeover and LBO business, firms issued "highly confident" letters and then provided capital directly. Now, they're providing bridge financing and taking equity interests in deals -- merchant banking.

Merchant banking is risk and with it comes potential enormous returns or losses. There is the risk that a junk bond will fail; a bridge loan will go unpaid; a company in which you have an equity interest will fail or be bought out at unfavorable terms. You may have to run a struggling company and there are conflicts of interest, i.e. being an advisor, lender and owner all in one.

Finally, we must become more adept at balancing our short-term and long-term needs. We have to boost our current earnings to generate the capital we need, and at the same time we have to position ourselves for tomorrow's competitive environment so we will be able to secure and maintain a leadership position. Management skills in this balancing will sort the men from the boys.

CONCLUDING ADDRESS

JOHN W. BACHMANN
MANAGING PRINCIPAL
EDWARD D. JONES & CO.

I'd like to start by asking the question, what is management? There are so many possible answers. Management is people. Management is systems. But today, for my purposes, I'd like to think of management in two ways. I think management is discipline and management is performance. Before we can measure the performance of management, we have to know what business we're in and that starts with a definition of a mission. That describes your purpose. And the mission is never to make money because to make money does not inform, it does not tell us what decisions to make or not to make in the long run. It does not define a higher expectation or something that people can unite behind. So we know it's not money.

At Edward D. Jones, the mission is a very short one -- it's to serve our customer, the individual, with reliable financial products, in unequaled service from convenient locations throughout America. Now, we don't do that yet, but that's something that we aspire to. The second thing is a part of the discipline -- a vision. Where is the organization going? How will it look in the future?

The third thing you need is goals or objectives, and those have to be measured. Those have to inform you of your performance, so you know how you're doing. And of course behind all that are your strategies -- how are you going to get where you're going? What are your strategies on training? So then, once that's in place, we can begin to think in terms of measuring performance.

The most difficult task of the manager is systematically thinking about the future. Why is it so difficult? Management requires objectivity, systematic thought, great patience with people. It also requires the ability to say no. And even more difficult, the ability to abandon, and it requires that we have a long-term focus. In a word, discipline. And it's difficult in a transaction business where people are so used to dealing instinctively, to be able to step away from that and take a long-term perspective.

At Jones, we have certain assumptions about the securities industry. It's clear that deregulation, which goes back to the early 1970s, has made a profound change on our business, a change that we feel today, because it has compressed margins. Deregulation attracted new, highly skilled and highly capitalized competitors. Companies such as American Express, General Electric, Sears, have found the industry very attractive. It's also shifting us from a relationship business to a transaction business. It's also forcing us away from a product focus toward a customer focus. It's also turned many of the traditional services into commodities. It's encouraging new product development. It's also increasing sharply the risks that we're forced to take, increasing the need for capital.

What are the responses to this kind of a competitive environment? It seems to me there are four. First, one can increase the velocity of current transactions -- in other words, do things more often, do them in larger quantities. One can also add components to the revenue stream, add new products, new services. We're seeing that. One can add value to the transaction or to the relationship -- certainly the computer is one way of transforming data into specifically tailored information as a way of doing that. And another way is to take greater risk, and we're certainly seeing that.

Now, looking at some of the tools of the manager, we've got to learn to be good marketers in our industry, because the new competitors that we are attracting to some extent are people who see the potential for marketing and believe that's what will give them their competitive advantage. I've come to believe that marketing is learning the wants and needs of the customer, so that you can deliver a product or service which the customer will recognize and embrace. Marketing is doing systematically what one does instinctively or haphazardly, and it is also simply organized common sense.

The second tool of the manager is technology. Technology is a way you're going to differentiate service, and the people that understand technology are going to have a big advantage if they can use it to deliver a product that makes, for example, the customer's monthly statement understandable.

The third tool is training. Along with technology, training is the other greatest productivity tool that's available. Training enables people to learn a system. It enables the organization to build expectations in people. It enables them to transmit the cultures, the values, the beliefs, and the legends that each of our organizations cherish.

The fourth is the organizational structure. Ben Edwards talked about how his organization is structured to focus on a common effort. Oddly enough, our own organization with no help from them, and them with no help from us, came to a very similar conclusion. At Jones, we have gone to great effort to be able to remain a partnership. We try and embrace and underscore this concept of partnership; you don't have to be a partnership to do it but we are and we still cherish that.

I'd like to take a look at the fifth area, which is capital. The ultimate measure of performance is return on capital over the cycle -- from peak to peak or valley to valley. Return on capital is diminishing, however, as competition increases.

I'd like to say a word about profits, because I think that people at times forget what profit really is. Profit is not revenue minus expense. You might think so, but it's not. Profit is revenue minus expense minus the cost of capital, plus the risk differential.

The sixth area I'd like to take a quick look at is control, and control is the instrument by which we steer. We look at aggregate numbers and as an organization grows, the aggregate numbers are so big that they're awesome. But we need to remind ourselves that numbers are relationships. Relationships tell us what we need to know, i.e. - margins.

We also look at percentages, return on capital per unit would be an example -- we are very concerned with cost per investment representative. These are the kinds of numbers that we need if we deal with what is clearly one of the key issues facing investment management or securities industry management today, which is white collar productivity.

The times today are no tougher than they've ever been. Our business tends to be one that when times are good, we exaggerate how good they are, and when times aren't so good, we exaggerate how bad they are. But the fact is, they tend to balance. And we forget this fact, and I catch myself doing it, and say -- boy, wait till things get back to normal. This is normal. You know, the most abnormal period in the modern history of America was 1950 to 1970 -- 20 years of economic expansion and rising markets is probably the biggest aberration in the history of the Republic. So these kinds of markets and these kinds of times with turbulence and uncertainty are normal. If we accept it, it makes life a little more understandable. And so as long as we keep in mind that every uncertainty, every crisis, creates opportunity, I see a very, very bright future for the securities industry.

VOLUME

	DEC 1987	YTD 1987	DEC 1986	YTD 1986	% CHAN YTD 1987-1986
AVERAGE DAILY SHARE VOLUME ON					
NYSE (MILS.)*	178.5	188.7	148.2	141.4	33.5%
AMEX (MILS.)*	13.4	13.9	12.3	11.8	17.2%
NASDAQ (MILS.)*	135.1	149.6	119.3	113.8	31.5%
REGIONAL EXCHANGE (MILS.)*	30.9	27.9	26.6	23.7	17.9%
DOLLAR VALUE OF SHARES TRADED ON					
NYSE (MILS.)	$114,214	$1,873,598	$122,915	$1,374,350	36.3%
AMEX (MILS.)	2,784	51,137	3,373	41,752	22.5%
ODD-LOT SHARES PURCHASED ON NYSE (THOUS.)	8,665	132,756	11,527	108,517	22.3%
ODD-LOT SHARES SOLD (INCLUDING SHORT SALES) ON NYSE (THOUS.)	17,155	208,782	27,150	220,640	-5.4%
NYSE BLOCK VOLUME AS A PERCENT OF TOTAL SHARES TRADED	48.9%	51.2%	49.8%	50.0%	----
CONTRACTS TRADED (THOUS.)					
CBOE OPTIONS	8,998	182,114	12,780	180,358	1.0%
AMEX OPTIONS	2,916	52,771	3,011	49,074	7.5%
COMMODITY	16,656	228,772	13,169	184,337	24.1%

*MONTHLY AVERAGE
N/A - DATA NOT AVAILABLE

UNDERWRITING

	FULL YEAR 1987	FULL YEAR 1986	% Change 1987-1986
CORPORATE FINANCING (Gross New Issues - $ Mils)			
TOTAL	$271,477.1	$286,039.6	-5.1%
Common Stock	$41,054.5	$43,037.3	-4.6%
# of Common Stock Issues	842	1,199	-29.8%
Preferred Stock	$11,361.1	$13,982.8	-18.7%
# of Preferred Stock Issues	160	187	-14.4%
Corporate Debt	$219,061.6	$229,019.5	-4.3%
# of Corporate Debt Issues	2,305	2,391	-3.6%
MUNICIPAL FINANCING (Gross New Issues - $ Mils)			
Negotiated	$76,034.9	$114,094.7	-33.4%
# of Issues	3,151	3,770	-16.4%
Competitive	$23,661.0	$33,446.7	-29.3%
# of Issues	3,340	3,913	-14.6%

Source: IDD Information Services

PRICES
(END OF MONTH)

	DEC 1987	DEC 1986	% CHAN YTD 1987-1986
DOW JONES INDUSTRIALS	1938.83	1895.95	2.26%
STANDARD & POOR'S 500	247.08	242.17	2.03%
NYSE COMPOSITE	138.23	138.58	-0.25%
AMEX MARKET VALUE INDEX	260.35	263.27	-1.11%
VALUE LINE COMPOSITE	201.62	225.62	-10.64%
NASDAQ COMPOSITE	330.47	348.83	-5.26%

RECENT INTERESTING READING AND STATISTICAL MATERIAL

Item	Description	Source
Report of the Presidential Task Force on Market Mechanisms	Detailed analysis by Brady Commission of the market break leading to the conclusion that: 1. from an an economic viewpoint, the markets for stock, stock index futures, and stock options are one and 2. given one market, there should be one agency with the authority to coordinate cross-marketplace issues. Unified clearing systems, consistent margin requirements, and "circuit breaker" mechanisms are among the Task Force's recommendations.	Commerce Clearing House 4025 W. Peterson Avenue Chicago, IL 60646 Report. no. 1267 Price: $6.00
The October 1987 Market Break	SEC staff finds the existence of futures on stock indexes and the use of various strategies involving program trading were a significant factor in accelerating and exacerbating the decline. Calls for curbs on speculation in stock index futures. Study recommends bolstering the financial strength of market-makers and encouraging greater disclosure of the identity of big buyers and sellers of stock.	Commerce Clearing House 4025 W. Peterson Avenue Chicago, IL 60646 Report no. 1271 Price: $9.00
Final Report on Stock Index Futures & Cash Market Activity During October 1987	Review of trading activities finds that the massive wave of selling that engulfed both stock and futures market was precipitated by an unprecedented change in investors' perceptions and not initiated by technical trading strategies which interacted with each other and the stock market. Urges better communications between exchanges.	Commodity Futures Trading Commission Office of Communication & Education (202) 254-8630
Financial Markets -- Preliminary Observations on the October 1987 Crash	GAO found two areas needing immediate attention to restore confidence in the markets. Given problems with automated systems during the crash, the GAO recommended that the SEC reassess its oversight role and capabilities for evaluating systems. Also recommended are intermarket contingency planning in order that self- and federal regulators can act in unison in dealing with any future market emergencies.	U.S. General Accounting Office P.O. Box 6015 Gaithersburg, MD 20877 5 copies free/ additional $2.00

Item	Description	Source
Banking Regulation in the Era of Financial Innovation	Dr. Klein explores the unique status of banks in the spectrum of private enterprises. Since banks are not like other businesses, they must operate under regulation designed to serve the economy and to allow efficient bank functioning. To improve the position of American banks, he recommends: 1. strengthening the deposit insurance system; 2. coordinating banking regulations and monetary policies with our global partners; and 3. maintaining regulations that steer banks into being good bankers rather than general financial institutions in the modern environment.	SIA Research Department (212)608-1500 $5 for non SIA members no charge for SIA members
"Capital Gains"	Authors Gravelle and Lindsey consider the general economic issues surrounding the taxation of capital gains. They conclude that a cut in the capital gains tax on corporate stock would likely increase the efficiency of the tax system. Also, they note that the existing limits on capital losses create an asymmetric tax treatment that could be reduced by lowering the capital gains tax rate. Finally, they agree that a cut in the capital gains tax rate would produce higher realizations, but whether the extra revenue would offset the cost of the rate cut is an area of disagreement.	Tax Notes 1/25/88
Transcript of: International Capital Markets Opportunities & Challenges	Deregulation. Innovation. Liberalization. These three forces have created new opportunities for overseas investors, issuers and intermediaries. Speakers at SIA's October 1987 International Conference commented on these three factors and their influence on today's global markets.	SIA Research Department $25 attendees $100 others

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AN ANALYSIS OF EMERGING TRENDS IN THE SECURITIES INDUSTRY
Produced by the SIA Research Department

Vol. XIV, No. 2 March 28, 1988

YOU CAN RUN BUT YOU CAN'T HIDE -- 1987'S KNOCKOUT PUNCH!

HIGHLIGHTS

1. The securities industry absorbed an unprecedented $2 1/4 billion pre-tax loss in 1987's final quarter. This was 22-fold the previous record loss of $100 million during 1984's second quarter and easily offset the $2 billion record quarterly profit booked in last year's first quarter.

2. The $2 1/4 billion pre-tax loss inflicted on the securities industry in 1987's final quarter is attributable to two P&L lines: a $1.3 billion loss in firms' investments and $720 million in error and bad debt costs.

3. For the year, the industry posted a mere $1.1 billion pre-tax profit. Not only was this an 80% free-fall from 1986's record $5.5 billion profit, it was, not even adjusting for inflation, the lowest level in nine years.

4. The securities industry's declining profit margin and return-on-equity were driven home by 1987's piledriving results. Last year's pre-tax profit margin and ROE of 2% and 4 1/2%, respectively, were 13-year lows.

5. During the fourth quarter, while the DJIA was losing one-third of its value in a week as all U.S. stocks lost $1 trillion in value, the securities industry's assets were slashed 20%, from about $500 billion to $400 billion.

6. Taking a longer-term view, the declining profitability in the securities industry is attributable to: volatile income sources coupled with runaway costs. Over the seven years ended in December, expenses skyrocketed 261%, easily outpacing a still-impressive 216% revenue rise.

7. Efforts in the last few years to reduce profit volatility have been fruitless. Since the industry has become more dependent on risk-taking activities, its profit picture has become more rather than less volatile. Securities firms have evolved from acting simply as customer agents, to taking principal positions in securities, and finally, to taking actual positions in companies.

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RETROSPECT

Disastrous -- the only way to describe the year just passed. Profits plummeted over 80%. The industry profit margin was the lowest in 13 years. Return on equity also fell to a 13-year low. The industry was hammered with a quarterly loss 22 times the magnitude of the previous record loss. Almost one-fifth of the industry's assets were wiped out in one quarter. Meanwhile, one-third of the Dow Jones Industrial Average was wiped out in just one week. The same week, $1 trillion was pared from the value of U.S. stocks. All global equity markets experienced panic selling. New negative records were set across the board, even dwarfing those set in the 1929 stock market crash. Disastrous!

A quote from the "Highlights" page of Trends one year ago this month: "In 1986, the securities industry earned a record pre-tax profit of $5.5 billion, up 33.1% over 1985's then record $4.1 billion." Now, update '88: in 1987, the securities industry earned just under $1.1 billion in pre-tax profits, down more than 80% from the previous year. Not even adjusting for inflation, 1987's profits were the lowest in nine years.

Following the October market collapse, the securities industry posted a record quarterly loss of $2 1/4 billion. That is 22-fold the previous record quarterly loss of $100 million experienced in the second quarter of 1984, which was also the last time the industry posted a quarterly loss.

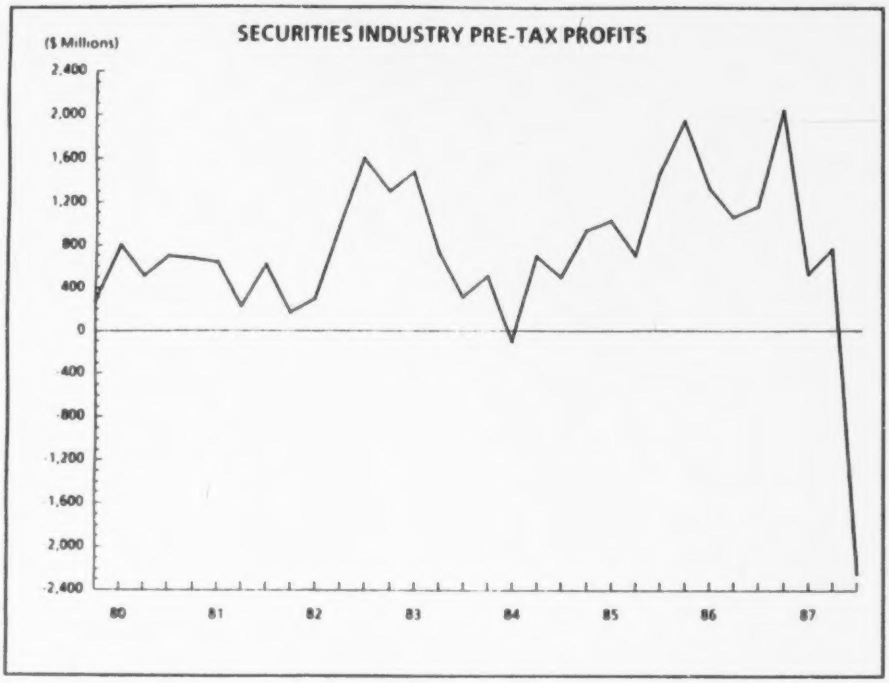
The fourth quarter's loss also exceeded in magnitude the record quarterly gain. That gain, a pre-tax profit of $2 billion, also came in 1987 - during the first quarter. If nothing else, this certainly highlights the volatility of the securities industry, which is generally regarded as the most volatile industry with regards to profits in the United States.

This volatility is best emphasized visually as shown by aggregate pre-tax profits on a quarterly basis during the Eighties. Table 1 certainly highlights the volatility in profits (and losses) and note how the peaks and troughs, and the swings between them, are getting larger.

As volatile as the quarterly profits in Table 1 appear, when these quarterly profits are plotted against other parameters, revenues and equity, not only is the volatility again highlighted, but a disturbing trend begins to unfold.

Tables 2 and 3 demonstrate the quarterly volatility in industry profit margin and return on equity, respectively. Clearly, the trend is downward, despite the bull market in equities for most of the interval being measured.

Table 1



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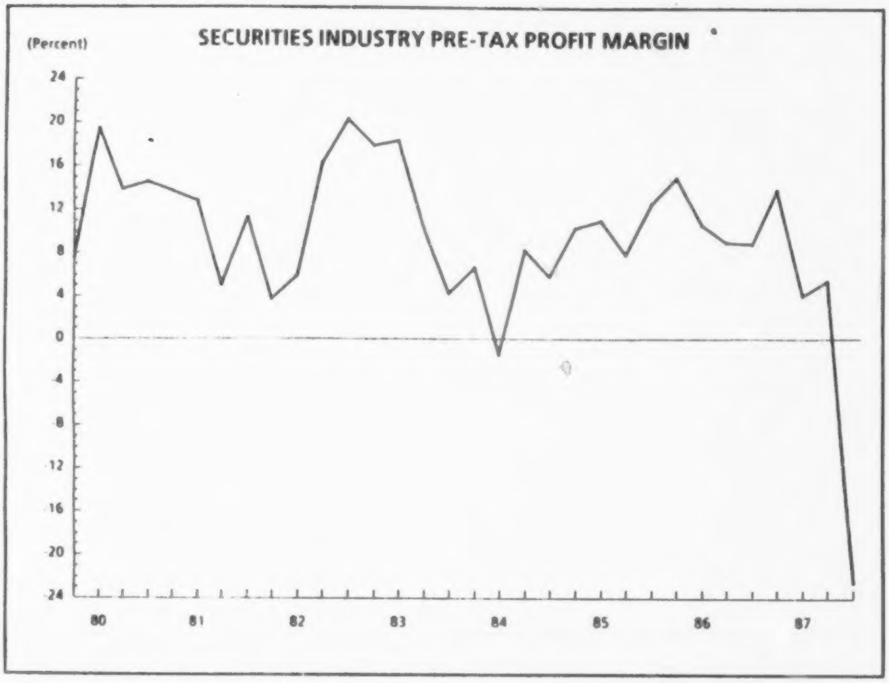

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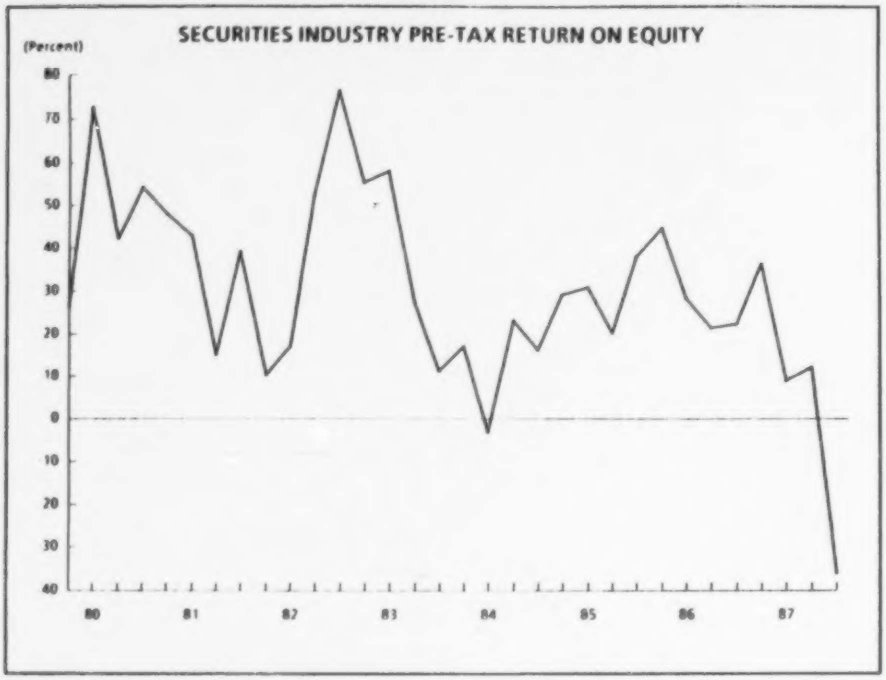

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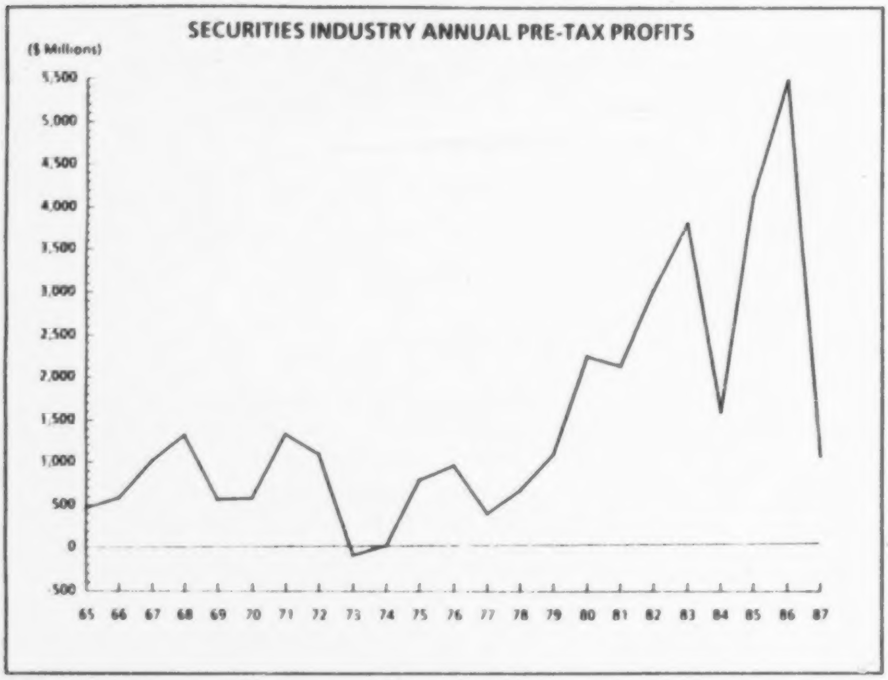
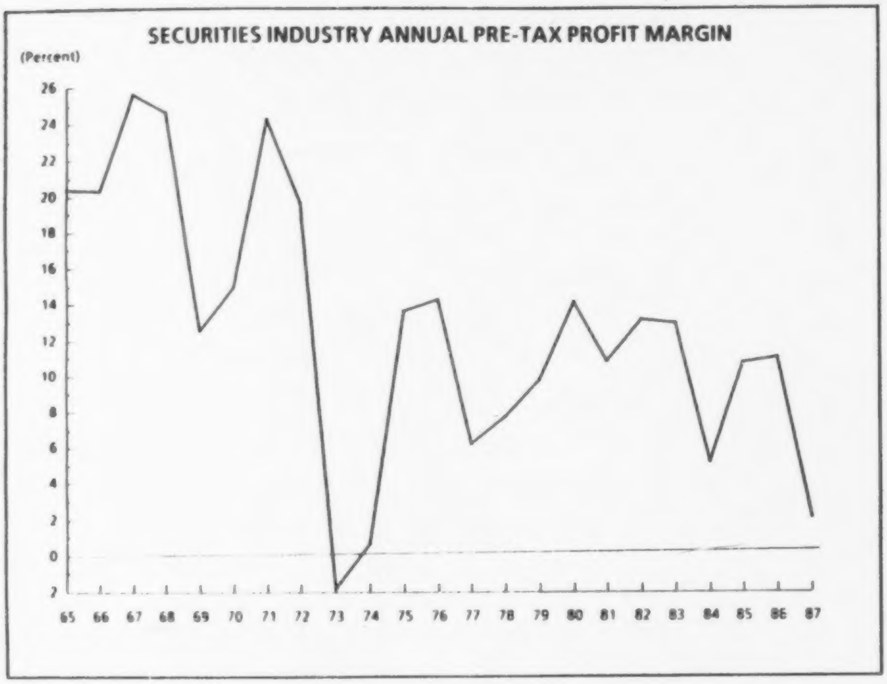


This trend towards reduced profitability is even more dramatic when looked at over a longer interval. Table 4 shows securities industry annual profits since 1965. Initially, despite the volatility and the fact that last year's profits fell back to 1960's levels, it appears that profits for the securities industry are trending upwards. But, since the aggregates are growing so large that they're awesome, it disguises the "real" profitability picture. Table 5 measures these profits against revenues and the resultant declining profit margin over the last 20 years is very alarming.

Table 5



Twenty years is a long time to ponder, especially with last year's record black and red ink barely dry on the industry's P&L sheet. A look at the quarterly income statement is both interesting and enlightening.

COMMISSIONS

Column 1 in Table 6 holds many industry quarterly records - the good kind, record revenues and profits. Commissions of $3.3 billion were the most posted in any quarter, although, $3.0 billion in the second quarter and $3.2 billion in the third and fourth were still very close and exceed every quarter of any other year. The record held in 1986 was $2.8 billion in quarterly commissions and in 1985 it stood at just $2.3 billion. For the year, commission revenues hit a record $12.6 billion, a 21% increase over 1986's then record $10.5 billion (Table 8).

October's market collapse was a collapse in price levels...for transaction volume it was anything but. Record 600 million share days helped generate record commissions. In 1986, volume on the New York Stock Exchange (NYSE) averaged 141 million shares per day. In 1987, average daily volume shot up to 185 million in the first quarter, slipped to 174 million in Q2, returned to 184 million in Q3 but skyrocketed to 212 million in Q4, thanks to October's record volume which averaged 277 million shares per day!

These commission revenues are basically the last remnant of the securities industry of old. An industry which derived more than half of its revenues from this nice, safe, agency commission business only 15 years ago has diversified to the point where only a fifth to a quarter of revenues now come from this "safe" business.

However, this safe business is extremely volume dependent, and after October's surge, volume spiralled downward and with it, commissions.

MARGIN INTEREST

Another equities-linked revenue source is margin interest. Here, again, October's action doesn't appear to have negatively affected the P&L. As Table 6 shows, margin interest fluctuated between $700 million to slightly over $900 million quarterly last year. This was well above the $700 million to $750 million range in 1986 and 1987's $3.3 billion annual tally was up 14% over 1986's level.

Although interest earned on margin accounts fared well all of last year, including the fourth quarter, there is a flip side to the equation. Interest expense, partly incurred to finance margin lending, ranged from $3.3 billion to $3.8 billion per quarter last year, higher than in any previous year. Also, the substantial risk exposure of this business was driven home in October.

Losses in error and bad debt accounts in the fourth quarter skyrocketed to $720 million, more than 3 1/2 times as large as the previous record amount, $203 million experienced in last year's second quarter. Exactly what proportion came from unsecured customer receivables vs. other sources, such as DKs, is not known but probably accounts for the majority of the increase.

Table 6

TOTAL INDUSTRY QUARTERLY INCOME STATEMENT

(In $ Millions)

Revenues	87:Q1	87:Q2	87:Q3	87:Q4
Commissions	3,312.2	2,984.9	3,164.7	3,180.0
Trading Profits	3,886.5	1,861.5	2,372.8	1,801.0
Investment Gains	770.0	284.5	301.5	(1,328.0)
Underwriting	1,453.5	1,483.9	1,552.4	664.0
Margin Interest	700.0	849.7	919.1	865.0
Mutual Fund Sales	792.0	614.0	442.5	360.0
Fees, Account Supervision	383.2	462.8	454.6	508.0
Research	24.6	6.8	7.0	3.0
Commodities	245.4	420.8	283.1	146.0
Other Securities Related	2,549.0	3,113.4	3,004.1	3,009.0
Other Unrelated	600.1	564.7	872.8	764.0
Total Revenues	14,716.5	12,647.0	13,374.4	9,972.0
Expenses				
RR Compensation	2,576.5	2,303.0	2,358.1	2,093.0
Clerical Compensation	2,528.6	2,294.0	2,360.9	1,894.0
Partner/Officer Comp.	403.0	387.6	314.2	403.0
Other Employee Comp.	152.5	174.2	158.9	150.0
Floor (Commission/Clearing)	514.2	535.1	580.5	558.0
Communications	609.5	631.7	645.2	668.0
Occupancy & Equipment	622.4	661.6	690.8	754.0
Promotional Costs	274.0	293.9	289.0	345.0
Interest Expense	3,311.7	3,526.7	3,827.2	3,608.0
Errors/Bad Debts	126.6	203.1	93.5	720.0
EDP	176.0	181.5	192.6	209.0
Non-Recurring Charges	4.5	5.8	9.3	80.0
Regulatory Fees	78.8	85.2	72.3	92.0
Other	1,289.9	834.5	1,046.0	643.0
Total Expenses	12,668.2	12,117.9	12,638.7	12,217.0
Pre-Tax Net Income	2,048.3	529.1	735.7	(2,245.0)

Table 7

NYSE MARGIN DEBT

($ Billions Outstanding, End of Month)

December '86	36.8	July	40.3
January '87	35.0	August	41.6
February	35.7	September	44.2
March	38.1	October	38.3
April	39.8	November	34.2
May	38.9	December	32.0
June	38.4	January '88	31.3
		February	32.0

Also, the trend in margin interest revenues is less than encouraging so far for 1988. Last year began with NYSE margin debt outstanding of $37 billion, by January's close it had fallen to $35 billion but gradually increased month by month to a record $44 billion outstanding as October opened. By October's close, however, the amount dropped to $38 billion, then $34 billion in November, $32 billion in December and fell again to $31 billion in January - the lowest level since April, 1986! However, February's amount increased slightly to $32 billion.

ASSET MANAGEMENT FEES

Another business area which securities firms are pinning some profitability hopes on in light of the market collapse is asset management. This area is viewed as generally bear-proof (although not for the portfolio itself) since it generates a stream of fee income in both bull and bear cycles. In fact, a record fee income of just over half a billion dollars was posted in last year's fourth quarter. Also, the second and third quarter's revenues of $450 million to $460 million each from this source trailed only the fourth quarter of 1987's $508 million and fourth quarter 1986's $506 million. This year has also witnessed a rash of offerings of income funds with above-average annual management fees which should also bolster this revenue source for 1988.

Furthermore, these figures understate the industry's revenue stream from asset management since the data is gleaned from FOCUS reporting of the broker-dealer entity only, and much asset management business is conducted outside of the holding company's broker-dealer subsidiaries.

Table 8

TOTAL INDUSTRY ANNUAL INCOME STATEMENT

(In $ Millions)

Revenues	1986	1987	% Change
Commissions	10,472.6	12,641.8	20.7
Trading Profits	12,560.8	9,921.8	(21.0)
Investment Gains	1,143.3	28.0	(97.6)
Underwriting	5,938.6	5,153.8	(13.2)
Margin Interest	2,919.5	3,333.8	14.2
Mutual Fund Sales	2,801.1	2,208.5	(21.2)
Fees, Account Supervision	1,466.7	1,808.6	23.3
Research	45.6	41.4	(9.2)
Commodities	1,064.7	1,095.3	2.9
Other Securities Related	9,552.0	11,675.5	22.2
Other Unrelated	2,119.0	2,801.6	32.2
Total Revenues	50,082.4	50,709.9	1.3
Expenses			
RR Compensation	9,183.8	9,330.6	1.6
Clerical Compensation	8,423.2	9,077.5	7.8
Partner/Officer Comp.	1,358.0	1,507.8	11.0
Other Employee Comp.	439.7	635.6	44.6
Floor (Commission/Clearing)	1,697.8	2,187.8	28.9
Communications	2,288.1	2,554.4	11.6
Occupancy & Equipment	2,178.5	2,728.8	25.3
Promotional Costs	1,036.4	1,201.9	16.0
Interest Expense	12,425.4	14,273.6	14.9
Errors/Bad Debts	431.9	1,143.2	164.7
EDP	632.2	759.1	20.1
Non-Recurring Charges	70.7	99.6	40.9
Regulatory Fees	310.1	328.3	5.9
Other	4,096.2	3,813.4	(6.9)
Total Expenses	44,570.9	49,641.8	11.4
Pre-Tax Net Income	5,511.5	1,068.1	(80.6)

INVESTMENT "GAINS"

Three-fifths of the $2 1/4 billion fourth quarter loss is directly attributable to securities identified as held for firm investments. The $1.3 billion loss in this column was nearly seven-fold as bad as the $200 million record quarterly loss on investments (Q4, 1986) and nearly double the magnitude of the record quarterly gain for investments ($770 million, Q1, 1987). Combining this $1.3 billion loss with the fourth quarter's record error/bad debt expense ($720 million), accounts for over 90% of the $2.2 billion loss during the fourth quarter alone.

The fourth quarter's losses for firms' investments can almost be forgiven, given the unprecedented markets during this period. However, since securities firms should be astute investors, over a longer time frame, particularly in bull markets, their quarterly performance should be biased upwards. Table 9 does not show this, however. Measuring quarterly percent swings in investment gains (losses) over the past five years, shows this revenue source declining just over half the time (11 out of 20 times).

Table 9

QUARTERLY PERCENT CHANGE IN INVESTMENT GAINS (LOSSES)

1983: Q1	-33	1985: Q3	-36
Q2	+ 19	Q4	+ 195
Q3	-84	1986: Q1	+ 40
Q4	+ 424	Q2	-4
1984: Q1	+ 11	Q3	-70
Q2	-101	Q4	-215
Q3	+ 10,667	1987: Q1	+ 484
Q4	-49	Q2	-63
1985: Q1	+ 80	Q3	+ 6
Q2	-22	Q4	-540

Table 9 also shows how cyclical and volatile firm investment gains/losses are, and this is the P&L line which reflects securities firms' new found love for taking principal positions in their merchant banking deals. Last quarter's $1.3 billion loss in this area effectively wiped out the previous three quarters' gains. Even on an annual basis, firms' performance over the past five bull-market years show mixed results (Table 10).

Table 10

ANNUAL PERCENT CHANGE IN INVESTMENT GAINS

1983	+ 22
1984	-3
1985	+ 53
1986	+ 5
1987	-98

TRADING

Although firms experienced some trading losses in the second and fourth quarters, mainly from bond inventories in the second quarter and equity inventories in the fourth, each quarter showed black ink in this area. In fact, 1987's first quarter gain of $3.9 billion was second only to the $4.0 billion gain posted in Q1 1986. But the year's annual $9.9 billion gain was down 21% from 1986's record $12.6 billion gain and was even edged out slightly by 1985.1/

Moreover, the quarterly swings were dramatic and in the case of some firms, trading losses in some quarters were extremely large, concentrated in a few securities and traders' desks, and led to departmental shake-ups and some new, and perhaps much warranted, positioning limits and controls.

As mentioned earlier, the securities industry's gravitation away from "riskless" agency-type businesses towards risk-based "principal" business lines, has taken its toll in terms of higher volatility. We've seen this volatility demonstrated earlier and it was also mentioned that commission's once dominant role in the P&L has been overtaken by these principal transactions. Forgetting underwriting, M&A, bridge loans, etc., for the moment and defining "principal" business as the sum of trading and investment gains, what impact on revenues and profits has been made by this shift?

Table 11 maps the quarter to quarter changes, in absolute dollar amounts, of principal business revenues to total revenues and pre-tax profits for the past three years. In all but the final quarter of 1986, increases in revenues and profits tracked that of principal business revenues. Not only was the direction, whether up or down, correlated, but the magnitude of the swings of all three were similar in most instances.

1/ Actually, the gains on firm securities trading accounts are biased upwards while any losses are biased downwards. This results from the instructions on the FOCUS Report. Dividends on equities and interest on fixed income securities held for trading purposes are included by firms when reporting their gains or losses from trading accounts. The inclusion of these revenue sources makes it difficult for a firm to report trading losses. For years, SIA analysts have requested the SEC to revise this way of reporting trading profits and losses. If the FOCUS Report is revised, and there are rumors that this is planned, one of the key changes to make the income statement more meaningful will be the separation of dividends and interest income from the actual gains and losses recognized by firms in their trading positions.

Table 11

QUARTER TO QUARTER CHANGE IN PRINCIPAL TRANSACTION REVENUES VS TOTAL REVENUES AND PRE-TAX PROFITS

(In $ Millions)

Quarter	85:1	85:2	85:3	85:4	86:1	86:2	86:3	86:4	87:1	87:2	87:3	87:4
Principal	57	62	(452)	1216	1099	(1177)	(393)	(215)	1882	(2511)	528	(2201)
Revenues	432	284	(393)	2756	1311	(445)	(711)	1208	1756	(2070)	727	(3402)
Profits	431	91	(318)	767	476	(619)	(266)	101	882	(1519)	207	(2981)

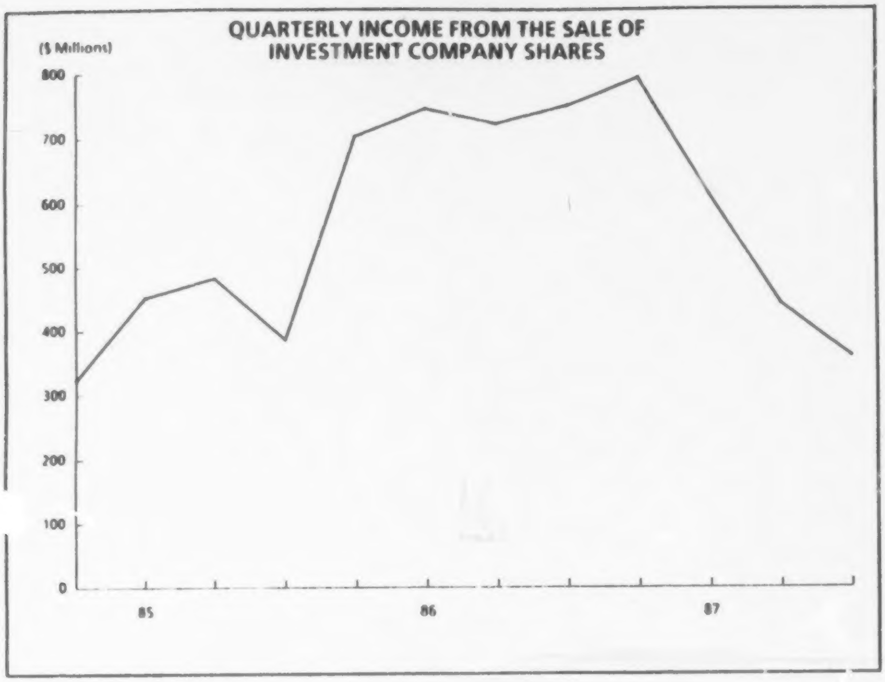
MUTUAL FUNDS

Following a decade of sustained growth, including the recent two banner years, 1985 and 1986 in which the sales of new mutual funds doubled annually, last year saw the first drop-off in this product. According to the Investment Company Institute (ICI), the trade group for the mutual fund industry, sales of all stock, bond and income mutual funds (excluding short-term municipal and money market funds) last year declined to $191 billion, down 12% from 1986's record $216 billion tally. The decline, however, when put in the perspective of the phenomenal growth this industry has witnessed, is relatively small. The ICI figures show sales of these funds more than doubling in 1985 to $114 billion from 1984's $46 billion and then nearly doubling again to 1986's record level.

Revenues from the sales of mutual funds for the securities industry fell an even steeper 21% last year. After more than doubling to $1.6 billion in 1985 from 1984's $751 million level, mutual fund revenues skyrocketed again in 1986 to a record $2.8 billion. Last year, revenues from this source fell to $2.2 billion.

On a quarterly basis, the growth, and then decline, of mutual fund sale revenues has been almost linear, rising from $323 million in the first quarter of 1985 to a peak of $792 million in the first quarter of 1987 and then retreating to $360 million in 1987's closing quarter (Table 12).

Table 12



UNDERWRITING

Corporates

Underwriting revenues were definitely not crash-resistant. This source of funds dropped from $5.9 billion in 1986 to almost $5.2 billion in 1987, or about 13%. But at that level it still contributed 10% to all revenues, dead center of the 8% to 12% range underwriting has contributed to total revenues since at least the early Seventies. However, as expected, very little of the underwriting revenue, or less than 13%, was derived during the fourth quarter. At October's open, underwriting revenues were running about 10% higher than 1986's first nine month results.

Excluding mortgage and asset-backed securities, which have mushroomed to now cover one-third of the volume of all corporate underwritings, both the number and the volume of corporate issues dropped from 1986, according to IDD Information Services. Whereas 2,650 issues were distributed in 1986, this number fell to 2,058 last year while the value of these offerings declined from $215 billion to $178 billion for the year.

Even including mortgage and asset-backeds, value declined from a record $286 billion to $271 billion. It must be remembered, however, that this level is still twice the value of the next largest year, 1985's $138 billion.

Except for mortgage and asset-backed debt, the decline in offerings was literally across the board. Straight (non-convertible) debt offerings dropped slightly from $219 billion to $209 billion, although the number of issues stayed between 2,100-2,200 offerings. Only $37 billion, or 18%, of that total was handled between October and December.

Convertible debt was off only slightly from $10.1 billion to $9.8 billion but, as would be expected of an equity-linked product, only 4% of this total or $0.4 billion, was underwritten in the fourth quarter; otherwise, converts were headed for a record year.

Lower grade issues of debt also declined from $32 billion to $29 billion, as the number of such offerings fell from 228 in 1986 to 192 in 1987.

As noted earlier, all security offerings were down except collateralized and mortgage and asset-backed debt. The value of mortgage and asset-backed debt jumped from $68 billion to a record $92 billion in 1987, while the number of deals also increased. Still growing in popularity, CMOs, or collateralized mortgage obligations, increased in volume from $47 billion in 1986 to a record $56 billion last year. The increase in asset-backed securities, backed by credit cards and auto loans, was much smaller, going from $10 billion to $11 billion in the last two years. The anticipated explosion in these repackaged securities, which many thought would mirror CMOs growth pattern, never materialized--$6 billion was underwritten in 1983, $11 billion in 1984, only $1 billion in 1985 and as said, $10 billion and $11 billion in 1986 and 1987. CMOs, while still by far the largest segment of the asset-backed market, comprised 61% of all asset-backed underwritings last year, down from 70% in 1986. Other mortgage-backed bonds more than doubled to $25 billion last year from 1986's $11 billion level.

The value of common stock offerings was down minimally from $43 billion to about $41 billion, although the number of offerings was off sharply, from 1,199 to 842. Before the market crash, however, common stock issuance was headed for yet another record year but fourth quarter issuances were pared to half the level of the year's previous quarters.

IPOs were just the opposite, increasing slightly in importance from just over $22 billion to slightly more than $24 billion, although the number of issues dropped from 719 to 541 as the average size increased. But post-crash was another story - November saw only seven deals totaling under $300 million and December's tally was just $566 million from eight deals. Furthermore, some of these IPOs are not pure equity offerings as they include unit trusts, particularly bond funds.

The value of equity issues distributed prior to the crash amounted to $48 billion, while that occurring after the crash came to just slightly more than $4 billion in total. The devastating effects of the crash can be seen by the fact that there were only 38 equity issues in total after the crash.

Municipals

The decline in underwriting long-term (exceeding 13 months) municipal issues since 1985 continued last year. In 1987, long-term municipals amounted to $104.6 billion, the lowest figure since 1983's $86.8 billion, according to IDD Information Services/PSA Municipal Database. Last year's figure was less than half the peak of $222.2 billion underwritten and distributed in 1985, when issuers rushed to the market to avoid many provisions contained in the Tax Reform Act of 1986. Besides affecting the profitability of the securities industry, the decline in the municipal market has also affected industry structure, as some firms have left this market completely or elected to shrink their municipal operations.

Both revenue and general obligation bonds declined by almost the same percentages from 1986 to 1987. In 1987, revenue bonds amounted to $74.1 billion, a drop of 32% from 1986's $108.4 billion. Likewise, general obligation issues fell to $30.4 billion from $42.9 billion in 1986, or a 29% decrease.

During the first quarter of 1987, refunding volume was heavy as issuers seized the opportunity of relatively low interest rates. Of the $33.2 billion of long-term issues underwritten and distributed, 70% was for refunding purposes. With rates increasing in the second quarter, total volume and the refunding percentage fell, with $26.7 billion issued and 43% of that amount representing refunding. With interest rates stabilizing more or less at higher levels for the rest of the year, the volume of new issuance declined and the segment reflecting refunding purposes fell to about 30%. Total offerings during the second half of 1987 came to $44.6 billion.

The anticipated growth of taxable municipals was not realized in 1987. Compared to 1986, taxable municipals fell from $4.5 billion to $3.7 billion, or a decline of 18%. Unless there is more growth in taxable municipals in the future, there is some question whether the municipal market will ever recover the peak reached in 1985.

According to the PSA, the outstanding value of municipal securities amounted to $715 billion as of the third quarter of 1987 compared to just under $690 billion at year-end 1986. Since 1982, the greatest growth in holdings of municipal securities have been in mutual funds concentrating in municipal securities and the household sector. Funds have increased their holdings by over $115 billion, an increase exceeding 540%. Meanwhile, households have increased their holdings by $146 billion, or about 118%. In contrast, commercial banks continue to decrease their holdings with a decline of $20.8 billion from year-end 1986 through the third quarter of 1987. Because of changes in tax provisions, commercial banks have reduced their municipal holdings by almost $50 billion, or 20%, since the end of 1985. This changing customer base sheds a great deal of light about those securities firms which have chosen to abandon or consolidate their municipal operations.

OTHER INCOME RELATED TO THE SECURITIES BUSINESS

The "other securities related" revenue line, comprised mainly of merger and acquisition (M&A) fees, private placement activities and U.S. Government securities repo/reverse repo revenues, also proved "crash" resistant. Not only that, but it has been rivaling commissions as a prime revenue source in recent years and last year even exceeded "principal" transactions and appears destined to become one of the industry's prime revenue sources, at least for the near future (Table 13).

On a quarterly basis, revenues from these sources held pretty even throughout the year. Totaling $2.5 billion in the first quarter, these businesses generated $3 billion in each of the next three quarters.

Table 13

SOURCES OF SECURITIES INDUSTRY TOTAL REVENUES

(In Percent)

Year	Commissions	Principal Transactions	Securities Related
1976	45.8	20.3	7.8
1977	41.7	19.3	8.5
1978	42.8	17.5	9.6
1979	35.8	23.6	10.3
1980	35.4	23.1	10.8
1981	27.0	24.3	15.0
1982	25.9	28.2	17.0
1983	28.2	25.6	14.8
1984	22.7	26.5	20.1
1985	21.3	28.5	18.6
1986	20.9	27.4	19.1
1987	24.9	19.6	23.0

Besides growing in importance to the total P&L, the aggregate revenues generated from "other securities related" sources have shown impressive annual increases. Table 14 highlights the growth in these revenues and the growth in the markets for two of the major business lines included in "other related," M&A and private placements.

Table 14

"OTHER SECURITIES RELATED" REVENUE VS. M&A AND PRIVATE PLACEMENTS

(In $ Billions)

Year	"Other Related" Revenues	M&A Purchase Price	Private Placements
1980	1.7	44.3	18.3
1981	3.0	52.6	18.5
1982	3.9	53.8	22.1
1983	4.4	73.1	36.4
1984	6.3	122.2	53.0
1985	7.2	179.5	73.0
1986	9.6	247.1	121.7
1987	11.7	216.7	135.1

All the aforementioned combined, total revenues increased again last year, albeit by only 1%. On a quarterly basis, however, the first quarter showed an all time record revenue of $14.7 billion, and with it a record $2 billion pre-tax profit. The third quarter's $13.4 billion in revenues was the second highest ever but the concurrent $736 million bottom line was far down on the list of profitable quarters. For the fourth quarter's $10 billion of revenues we have to return to

1985 to find a smaller quarterly showing and the fourth quarter's disastrous bottom line has already been discussed.

EXPENSES

In an earlier part of this paper, we noted the deterioration in pre-tax profit margins and ROEs during the 1980s. Last year dramatized this trend. Given the disastrous fourth quarter, the percent change in revenues, 1.3%, was far surpassed by the percentage change in costs, 11.4%. As discussed earlier, basically two lines -- one a revenue source, the other an expense item -- accounted for the disastrous 1987. With losses in the investment account exceeding $1.3 billion during the fourth quarter and bad debts of $720 million during that same quarter, these two factors alone were responsible for over $2 billion of the $2.2 billion in losses during that quarter.

In addition to the tremendous losses in the investment account, it was clear that other revenue sources faltered during the fourth quarter. In particular, trading profits, underwriting revenues, mutual fund sales and commodity revenues all tailed off sharply after the third quarter. As far as expenses are concerned, besides the surge in bad debts, only non-recurring charges showed a sharp upswing during the fourth quarter. All other cost items more or less reflected roughly 25% of the year's costs during the fourth quarter.

Rather than get caught up in the drama of 1987 alone, we feel it is important to take a longer term perspective concerning profitability trends in the securities industry. Thus, we compared the percent change in revenues versus the percent change in expenses since year-end 1980. Since profit margins have been deteriorating throughout the eighties, it is no surprise that expenses have been rising faster than revenues. To be exact, from year-end 1980 through year-end 1987, expenses have risen about 261% as compared to a revenue rise of 216%.

Despite all the widespread publicity and hoopla about extravagant salaries and bonuses in the securities industry, employee and partner compensation has not been the main culprit behind the surge in expenses during this time period. Combining all compensation items since year-end 1980, these costs have risen 223% as compared to the total expense increase of 261%. Thus, it is noncompensation costs that have risen more dramatically during this time period. The chief culprits are occupancy and equipments costs (431%), EDP expenses (386%), and interest expense (314%).

Although compensation does not appear to have been a major culprit accounting for the deterioration in profit margins since year-end 1980, it has been a major contributor to this deterioration in recent years. For example, during the period 1985 through 1987, compensation in the industry was rising nine percentage points faster than total revenues (40% vs. 31%). If the period is extended by one year from 1984 through 1987, compensation was rising 14 percentage points faster than revenues, or 76% as compared to 62%. In other words, from 1984 through 1987, the securities industry got lackadaisical in terms of compensation rates rising considerably faster than revenues. This contrasts with the period 1980-83, when compensation costs rose 88.5%, while revenues were jumping 84.4%.

Table 15

REVENUES AND EXPENSE CHANGES FROM 1980-1987

Revenues	1980-1987
Commissions	122.5%
Trading Profits	216.2
Investment Gains	(95.0)
Underwriting	288.1
Margin Interest	59.6
Mutual Fund Sales	2009.4
Fees, Account Supervision	931.1
Commodities	75.1
Other Securities Related	575.8
Total Revenues	216.3
Expenses	
Total Compensation*	223.0
RR Compensation	205.9
Clerical Compensation	256.2
Partner/Officer Comp.	165.6
Communications	205.0
Occupancy & Equipment	430.8
Promotional Costs	246.2
Interest Expense	314.4
Errors/Bad Debts	459.0
EDP	386.3
Total Expenses	260.6

* Excludes other employee compensation.

Meanwhile, interest expense, the second largest single expense item for this industry, behaved very differently. During the period year-end 1980 through 1987, interest expense rose by 314% as compared to a revenue increase of 216%. However, most of the increase in interest expense relative to revenues was in 1984. From 1984 through 1987, interest expense rose 50% as compared to a revenue increase of 62%. This is startling, given an increase in revenues of only 1.3% during 1987. However, a trend of declining interest rates in general played an important role in limiting the increase in interest expense for most of the 1980s. Except for 1984 and 1987, interest expense rose at a slower rate than revenues.

We conclude that this industry has benefited from sharp increases in revenues which have more than doubled during a seven year period from year-end 1980 through 1987. However, unfortunately, expenses have risen at an even faster rate, growing 261% during this same time period. Surprisingly, the main culprits during this time period have not been compensation, but such costs as EDP expenses, occupancy and equipment costs, interest expense, and errors and bad debts. No single expense item has increased by less than double during this seven year period of time.

Although there were numerous warnings in this publication as well as elsewhere about costs getting out of control, these problems were masked by rapid rises in revenues which hid the underlying problems plaguing the industry. With the abrupt slowdown in revenue growth, dramatically evidenced by last year's fourth quarter, the industry is now forced to grapple with its underlying cost problem. This was reflected in the great interest indicated in the joint workforce study, "Wall Street's Workforce," soon to be published by SIA and Arthur Andersen.

Every manager in this industry has become cost conscious because of the change in atmosphere and environment facing the industry today. We remain confident that the industry will bounce back from these troubled times as it has with other larger challenges in the past. Cost control is not so much an impossibility as a troublesome and difficult problem requiring the willingness to deal with it. Now that managers realize this, maybe it will be possible to return to the days where ROEs and profit margins expanded as revenues increased such as during the Eighties. Managers in this industry should not be content with simply seeing increases in profits due to greater employment of capital and increased risk. Satisfaction should only return when profit margins and ROEs return to their upward trend as was the case for many of the years in the 1970s and several in the 1980s.

CONCLUSION

The securities industry has just gone through a disastrous, if not wrenching, year. After a promising start during the first quarter of the year, the market break in October was mainly responsible for the industry seeing its return on equity and profit margins falling to 13 year lows. Certainly, the fourth quarter loss exceeding $2.2 billion was unprecedented and 22 times the size of the previous record quarterly loss. Almost one-fifth of the industry's assets were wiped out in one quarter while one-third of the Dow Jones Industrial Average was wiped out in just one week. Given that new negative records were set across the board, the reader can select his own adjective to describe last year's impact on the securities industry whether it be disastrous, wrenching, or another word with equally dramatic and depressing overtones.

Few individuals, if any, can ignore and shrug their shoulders at the developments which occurred during October and the subsequent weeks. Coming on top of 1986's record pre-tax profits of $5.5 billion, which reflected a 33% increase over 1985's then record profits, made 1987's performance that more disappointing and bewildering.

Although this industry has lived with volatility for quite some time, it had never experienced volatile swings in earnings, profit margins and ROEs like that witnessed last year. This is bound to have psychological and long-term repercussions in how investors and firms view risk and the willingness to commit to risk-taking ventures. More and more investors now understand that liquidity is not a free good, but something that has to be paid for.

Most importantly, despite strenuous efforts over the last few years to reduce earnings volatility in this industry, these efforts have more or less been fruitless.

As the industry has been forced to rely further and further on principal-type activities, its earnings by definition have had to become more volatile, relying on risk-taking activities. We have made a complete transformation from acting as an agent, to taking positions in securities, to taking positions in companies.

Like other investors, securities firms were not unique in making mistakes concerning trading and investment positions. When a relatively few number of institutions all decided to head for the exit at the same time and to lighten up on their stock positions, the required liquidity was not available for their needs. The result was a plunge in stock prices and a scramble by these institutions to get out at any price. The impact on other more patient and presumably more value conscious investors who do not rely on complicated mathematical formulas telling them whether to buy or sell was devastating.

Most securities firms had been aware for some time that the relentless rise in expenses has had a serious dampening effect on their profit margins and return on equity. However, cost control is a difficult proposition forcing managers to say no to many proposals and to win few allies in doing so. It is much easier from a managerial and political viewpoint if revenues can be generated fast enough so everyone's desires for additional space and fancier quarters, as well as higher salaries can be met.

Even before the fourth quarter of 1987, firms were aware that the slowdown in revenues was forcing them to reevaluate earlier decisions that were causing expense increases. Several chose to look at several different businesses and given deteriorating profits and margins in those businesses to reduce their commitment or eliminate those segments from their product line entirely.

This is an industry of very entrepreneurial and intelligent individuals, and when revenues more than double over a seven year period and yet profit margins deteriorate it is obvious that expenses are a major problem. Surprisingly, compensation has not been the expense item causing the most problem relative to other costs or even revenues, although it remains the single largest expense segment for the industry and thus is usually one of the first targets of the firm's cost-cutters. Indeed, only in the years from 1984 through 1986 did firms seem to let this cost item get out of hand and increase too fast relative to revenues. Rather, investments in new technologies sometimes were too fancy with all the "bells and whistles" attached, and new and fancier quarters were simply adding to the fixed overhead of firms which they attempted to finance through processing and delivering ever greater and greater numbers of products. In conversations with securities firms, we think this painful lesson has finally been learned and a reluctance to add to overhead seems to now be ingrained in management's psyche.

Despite the wrenching change this industry has just gone through, we remain optimistic about the ability and ingenuity of management to solve the problems and return this industry back to periods of high profitability. We say this quite aware of the additional competition looming around the corner as discussions in Congress about giving banks additional securities powers proceed. The ability of securities firms to prosper has never depended on meeting the current competition, but rather finding unique niches and developing abilities to serve the investor by keeping one step ahead of the current and future competition.

This is an industry of constant change. As we are writing this issue, many large firms are seeing M&A experts leaving and starting up their own boutiques. Clearly, the evolution of the industry continues right before our eyes. Whether this will have a significant impact on those firms losing such experts remains to be seen, although the "market" seems to think so. However, our main conclusion remains the same: an industry that is used to constantly meeting challenges successfully is usually able to meet additional challenges as they come along. In other words, challenge and change is the norm for the securities industry rather than a unique phenomenon occurring once every few years.

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VOLUME

	JAN 1988	YTD 1988	JAN 1987	YTD 1987	% CHAN YTD 1988-1987
AVERAGE DAILY SHARE VOLUME ON					
NYSE (MILS.)*	174.8	174.8	193.1	193.1	-9.5%
AMEX (MILS.)*	9.9	9.9	14.8	14.8	-33.1%
NASDAQ (MILS.)*	123.3	123.3	151.8	151.8	-18.8%
REGIONAL EXCHANGE (MILS.)*	N/A	N/A	29.4	29.4	N/A
DOLLAR VALUE OF SHARES TRADED ON					
NYSE (MILS.)	$115,710	$115,710	$163,620	$163,620	-29.3%
AMEX (MILS.)	2,413	2,413	4,935	4,935	-51.1%
ODD-LOT SHARES PURCHASED ON NYSE (THOUS.)	7,648	7,648	11,321	11,321	-32.4%
ODD-LOT SHARES SOLD (INCLUDING SHORT SALES) ON NYSE (THOUS.)	12,690	12,690	19,103	19,103	-33.6%
NYSE BLOCK VOLUME AS A PERCENT OF TOTAL SHARES TRADED	52.1%	52.1%	50.8%	50.8%	----
CONTRACTS TRADED (THOUS.)					
CBOE OPTIONS	9,059	9,059	19,455	19,455	-53.4%
AMEX OPTIONS	2,986	2,986	4,789	4,789	-37.6%
COMMODITY	18,854	18,854	15,916	15,916	18.5%

*MONTHLY AVERAGE
N/A - DATA NOT AVAILABLE

UNDERWRITING

	JAN 1988	JAN 1987	% Change 1988-1987
CORPORATE FINANCING (Gross New Issues - $ Mils)			
TOTAL	$18,396.7	$23,456.0	-21.6%
Common Stock	$970.1	$2,334.0	-58.4%
# of Common Stock Issues	16	40	-60.0%
Preferred Stock	$1,068.0	$420.7	153.9%
# of Preferred Stock Issues	17	9	88.9%
Corporate Debt	$16,358.6	$20,701.3	-21.0%
# of Corporate Debt Issues	217	216	0.5%
MUNICIPAL FINANCING (Gross New Issues - $ Mils)			
Negotiated	$4,443.3	$7,131.4	-37.7%
# of Issues	119	161	-26.1%
Competitive	$1,494.3	$856.7	74.4%
# of Issues	77	50	54.0%

Source: IDD Information Services

PRICES
(END OF MONTH)

	JAN 1988	JAN 1987	% CHAN YTD 1988-1987
DOW JONES INDUSTRIALS	1958.22	2158.04	-9.26%
STANDARD & POOR'S 500	257.07	274.08	-6.21%
NYSE COMPOSITE	144.13	156.11	-7.67%
AMEX MARKET VALUE INDEX	269.10	300.47	-10.44%
VALUE LINE COMPOSITE	210.73	249.17	-15.43%
NASDAQ COMPOSITE	344.66	392.06	-12.09%

RECENT INTERESTING READING AND STATISTICAL MATERIAL

Item	Description	Source
"An Analysis of Banking and Securities Industry Profitability"	Study documents securities industry profitability and the volatility of earnings over time and compares them to the banking industry. Two basic points are made: 1. Profits from the securities industry are not large enough to have a meaningful impact on the earnings of the banking industry. Moreover, the securities industry is too volatile to be combined with the banking industry for public policy purposes. 2. Losses of $2.2 billion in the fourth quarter alone for the securities industry show the volatility and high risk nature of this industry and to join the to industries violates common sense in pursuing a safe and sound banking system.	SIA Research Department
How Capital Gains Tax Rates Affect Revenues: The Historical Evidence	Newest government study on the relationship between realizations of long-term capital gains and tax rates on capital gains. New simulation used offer support that higher tax rates lower realizations of capital gains, producing less revenue when incorporating a behavioral analysis than based on static analysis alone. Nevertheless, study finds the 1986 tax change in capital gains will yield a net revenue increase, and the proposed lowering of the capital gains rate to 15% would yield a net revenue loss. In addition, study indicates capital gains revenues would be maximized at marginal rates between 25% and 33%.	Congressional Budget Office Second & D Street,S.W. Washington, D.C. 20515
"Packaging Protection"	Firms admit there's little enthusiasm to create innovative products that would urge investors to get in on the ground floor of new opportunities created by the changing market environment. So firms are packaging products, often in unit investment trusts. However, some brokers and money managers are using aggressive strategies also to catch market opportunities.	Registered Representative March 1988

Source	Item	Description
"False Alarm-Foreign Investment Should be Welcomed, Not Feared"	The free economy may be on permanent trial but the charges tend to change. In past years the charge was that multinationals were moving jobs offshore. With the swing in exchange rates and global firms eager to expand U.S. operations, the charge is the "evils" of foreign investment. Author offers a scathing review (based on common sense) of both Buying Into America and the pending Bryant amendment.	Barron's 3/21/88
"A Consumption Tax"	Two articles. First article discusses the political and economic background in which a consumption type tax would be considered. Given little hope of balancing the budget without new revenue, the VAT is one alternative to assist in closing the gap if Congress decides against raising income taxes. The second article assesses the efficiency and equity of a VAT. Concludes VAT would make the tax system less progressive and compared to an income tax, would redistribute income from older to younger individuals.	Tax Notes 3/7/88
"The FW 1,000"	List of the 1,000 largest companies traded on U.S. markets ranked by market value. Other key yardsticks to appraise corporate performance include sales, ROE, and "relative strength"-- price change over the past 12 months. Highlights: 20 highest yielding stocks, fastest growing companies, and most profitable companies.	Financial World 4/5/88
SIA 1988 Directory & Guide	A guide to the membership, organization and services of SIA. Includes officers and members of the Board of Directors, committee members, and division and district leaders.	SIA Publications Dept.

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AN ANALYSIS OF EMERGING TRENDS IN THE SECURITIES INDUSTRY
Produced by the SIA Research Department

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TWO DIFFERENT WORLDS

HIGHLIGHTS

Eight long months have passed since October's quake rocked the securities industry and opened a gaping fissure into which much of the industry's previous profits sank. In its wake was left a split securities world. This brave new world now sees the trading/investment banking hemisphere rapidly accelerating on its merchant-banking based axis while the retail hemisphere has almost ground to a halt. The following are a few highlights of this post-crash, split-world, securities industry analysis:

1. This year's first quarter commission revenues, retail's staple, fell to $2.4 billion, the lowest quarterly showing since 1985.
2. The first quarter's $3.1 billion trading gain was the third highest ever while the $827 million investment gain was a quarterly record, reversing this line's Q4 record loss.
3. Disregarding these two "hemispheres'" vast differences, the "total" securities industry's 1988 first quarter profit margin and ROE roughly tripled over 1987's full-year level.
4. National Full Line, Discounter and Regional firms' bottom lines were all severely impacted by retail's Q1 anemic activity while Large Investment Banks and their smaller New York City-based cousin firms saw profits soar on a merchant banking geyser.
5. Cost cutting and expense control measures, however, seem to be taking hold with Q1 expenses declining faster than anticipated given revenue's fall-off. Highlighting this was a pare-back in more than 14,000 jobs, or over 5% of the workforce, in the six months since the crash. We believe there remain too many encouraging signs to project the demise of firms focusing on the retail customer.
6. Likewise, we believe merchant banking activities are not the only strategy for finding a panacea to the industry's problems. LBOs and similar strategies have flourished in a strong economy with stable interest rates. Under more adverse conditions, merchant banking will face challenges that must be overcome if they are to become a permanent fixture of the securities industry's business.

INTRODUCTION

Eight long months have passed since "that day" and all is not right in the securities world. Granted, this year has not registered another October quake off the Richter Scale, but the aftershocks are still being felt. Actually, these aftershocks are mostly felt in one hemisphere -- retail -- but that's where most firms reside. For the investment banking/trading hemisphere, October's rubble has been cleared and rebuilding is mostly complete.

Without even looking at categories of firms' results (i.e. Regionals, Large Investment Banks), the first quarter's "total industry" picture held some not-so-subtle hints that the two hemispheres are each spinning on a quite different axis. Commission revenues, the land of retail's manna, fell to $2.4 billion, a full-blown famine -- it was the lowest quarterly figure since 1985. On the other side of the globe, meanwhile, the "principle position" people were reaping their harvest. Trading profits soared to $3.1 billion -- the third highest quarter ever, only behind the phenomenal first quarters of 1986 and 1987. Investment profits also shot out of the fourth quarter's record $1.3 billion loss crevice, volcanoing to never before seen heights -- $827 million in gains (which still doesn't make up for the Q4 fiasco and again highlights merchant banking's volatility and risk).

No seismologist was needed to read the remaining retail revenue line tremors: mutual fund revenues, until early last year continually registering growth off the scale, fell back to 1985 levels (since that year, only last year's fourth quarter trough was lower).

Meanwhile, other investment banking movers and shakers were as active as ever. The "Other Revenue Related to the Securities Business" P&L line (the FOCUS Report's way of reporting M&A, Private Placement and Repo activity) kept pace with last year's $3 billion record quarterly clip.

If we ignore the vast differences of the industry's two hemispheres, the "total industry" booked $13 billion in revenues during this year's first quarter -- the third best quarter ever in revenue; behind only last year's record Q1 total of $14.7 billion and Q3's $13.4 billion! Wearing the same blinders, the "total industry" also booked a pre-tax profit of $1.1 billion in this year's first quarter, nearly matching last year's full year (although crash-impacted) pre-tax profits of $1.2 billion. Annualized, the first quarter's profits would only trail 1986's record $5.5 billion annual profit showing.

Although one sometimes can't see the trees for the forest when analyzing "total industry" data, especially of late, the following still puts the state of the securities industry in a little clearer perspective.

Q1 1988 TOTAL INDUSTRY

Despite a lot of moaning and groaning, the good news is that the industry's pre-tax profit margin and ROE roughly tripled from 1987 to the first quarter of 1988. Indeed, despite what many individuals perceived as a relatively weak first quarter, the annualized figures would provide results also surpassing that of 1984. For the industry, pre-tax profit margin and ROE came in at 8.7% and 18.1%, respectively, on an annualized basis. The bad news is that these percentages were roughly 80% and two-thirds, respectively, of that reached in 1985 and 1986, years when the industry's deterioration in these key ratios were already becoming increasingly apparent to observers.

Table 1

PRE-TAX PROFIT MARGINS
(In Percent)

Firm Category	80	81	82	83	84	85	86	87	88*
National Full Line	10.9	6.9	8.8	8.6	(0.9)	5.6	6.9	(0.9)	1.4
Lg. Investment Banks	17.7	15.4	17.4	16.7	11.4	14.6	13.5	4.7	11.9
Regionals	14.7	11.2	11.1	12.6	2.6	9.4	11.0	5.5	4.3
New York City Based	14.8	12.6	14.0	18.3	8.9	12.3	16.1	2.2	15.8
NYSE Discounters	17.5	12.2	13.6	14.0	0.3	8.9	15.7	8.6	3.8
Total Industry	**14.1**	**10.8**	**13.1**	**12.9**	**5.2**	**10.7**	**11.0**	**2.3**	**8.7**

* First quarter.

PRE-TAX RETURN ON EQUITY
(In Percent)

Firm Category	80	81	82	83	84	85	86	87	88*
National Full Line	45.0	24.6	29.8	28.1	(2.6)	17.9	20.3	(2.1)	2.9
Lg. Investment Banks	55.7	56.7	54.8	43.8	31.1	38.5	34.2	9.3	25.6
Regionals	N.A	37.2	36.0	40.5	6.8	29.0	32.7	14.1	9.2
New York City Based	N.A	42.1	43.3	50.7	19.9	31.2	35.4	3.9	33.1
NYSE Discounters	N.A	52.2	53.9	46.7	0.8	25.6	49.5	19.7	6.4
Total Industry	**49.2**	**35.9**	**40.5**	**36.6**	**13.3**	**29.4**	**28.6**	**4.9**	**18.1**

* First quarter annualized.

Other good news is that the industry's quarterly net income jumped from less than $300 million in 1987 to over $1.1 billion during Q1 1988. However, Q4's record $2.1 billion loss really dragged down the 1987 quarterly average, wiping out Q1's record $2.0 billion profit. Still, firms must live with the "net" for the whole year so this profit jump is quite impressive since first quarter 1988 revenues were up only 2.5% from average quarterly revenues for 1987.

Fortunately, cost-cutting measures and expense controls are now becoming effective at securities firms. Quarterly costs were down over 4% from the average for last year. Naturally, some of these cost declines were attributable directly to revenue declines, which move in tandem with certain costs such as RR compensation. Keeping an eye on the big picture, two of the three major cost categories -- interest expense and RR compensation -- fell during Q1 1988 (the declining RR compensation expense actually registered its biggest nose-dive in last year's final quarter). These two cost components make up almost 46% of the total costs of the securities industry. If clerical and administrative compensation were included, we would be describing cost trends accounting for two-thirds of the industry's total expenses.

Because of their relative importance, the relentless increase in clerical and administrative compensation as well as occupancy and equipment costs remain of grave concern. Both of these costs rose 8-10% during Q1 1988 relative to the quarterly average for 1987 hinting at "stickiness" in a downward direction. Clerical compensation, in fact, climbed back up to last year's first quarter record level of $2.5 billion, exceeding Q2 through Q4's $2.3 billion, $2.4 billion and $1.9 billion levels, respectively!

Table 2

STATEMENT OF INCOME
TOTAL SECURITIES INDUSTRY

(In $ Millions)

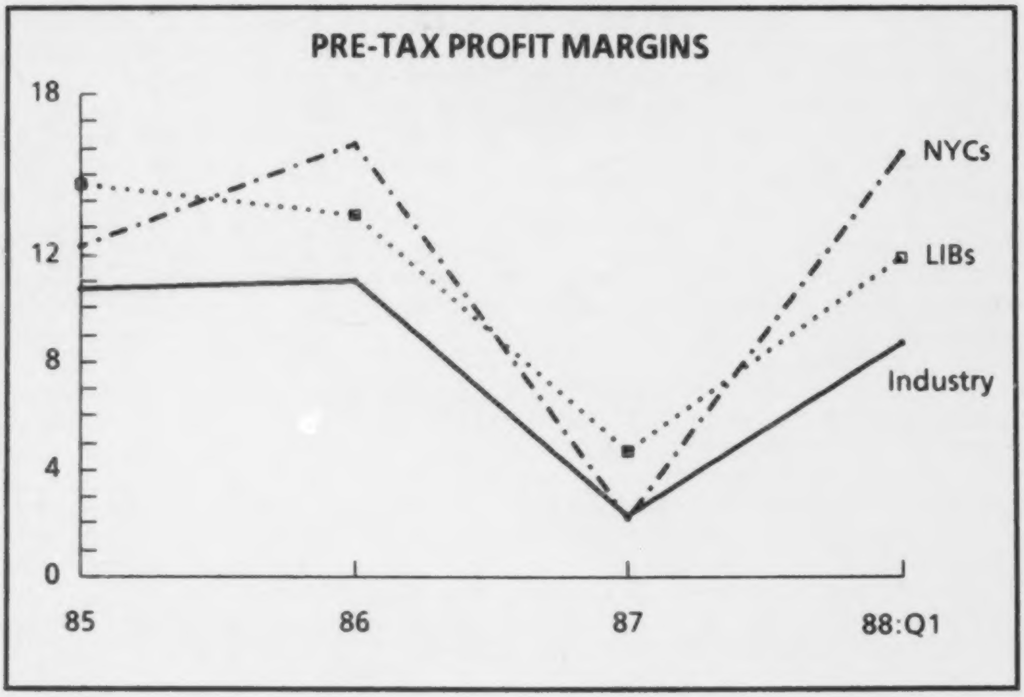
Revenues	1986	1987	% Chg.	Quarterly Avg. 1987	88:Q1	% Chg.
Commissions	10,472.6	12,646.4	20.8	3,161.6	2,424.2	(23.3)
Trading Profits	12,560.8	9,972.5	(20.6)	2,493.1	3,110.4	24.8
Investment Gains	1,143.3	67.8	(94.1)	17.0	827.8	N/A
Underwriting	5,938.6	5,156.8	(13.2)	1,289.2	1,187.6	(7.9)
Margin Interest	2,919.5	3,352.3	14.8	838.1	657.5	(21.5)
Mutual Fund Sales	2,801.1	2,208.8	(21.1)	552.2	430.0	(22.1)
Fees, Account Supervision	1,466.7	1,811.5	23.5	452.9	345.9	(23.6)
Research	45.6	24.4	(46.5)	6.1	9.8	60.7
Commodities	1,064.7	1,093.4	2.7	273.4	366.7	34.1
Other SecuritiesRelated	9,552.0	11,680.4	22.3	2,920.1	2,930.1	0.3
Other Unrelated	2,119.0	2,798.5	32.1	699.6	725.6	3.7
Total Revenues	50,082.4	50,811.0	1.5	12,702.8	13,015.9	2.5
Expenses						
RR Compensation	9,183.8	9,335.1	1.6	2,333.8	2,054.0	(12.0)
Clerical Compensation	8,423.2	9,079.6	7.8	2,269.9	2,469.6	8.8
Partner/Officer Comp.	1,358.0	1,508.1	11.1	377.0	354.3	(6.0)
Other Employee Comp.	439.7	630.7	43.4	157.7	138.9	(11.9)
Floor (Commission/Clearing)	1,697.8	2,188.3	28.9	547.1	446.5	(18.4)
Communications	2,288.1	2,555.7	11.7	638.9	610.8	(4.4)
Occupancy & Equipment	2,178.5	2,729.3	25.2	682.3	749.2	9.8
Promotional Costs	1,036.4	1,203.1	16.1	300.8	233.3	(22.4)
Interest Expense	12,425.4	14,271.3	14.9	3,567.8	3,364.7	(5.7)
Errors/Bad Debts	431.9	1,142.9	164.6	285.7	110.2	(61.4)
EDP	632.2	759.5	20.1	189.9	181.9	(4.2)
Non-Recurring Charges	70.7	99.5	40.7	24.9	11.4	(54.2)
Regulatory Fees	310.1	328.0	5.8	82.0	87.2	6.3
Other	4,096.2	3,806.3	(7.1)	951.6	1,074.8	12.9
Total Expenses	44,570.9	49,638.9	11.4	12,409.7	11,886.8	(4.2)
Pre-Tax Net Income	5,511.5	1,172.1	(78.7)	293.0	1,129.1	285.4

RR compensation's drop was to be expected. First, the level of business and RR production has fallen dramatically since the crash. According to another SIA publication, "Production and Earnings of RRs," during the first six months after the crash, average gross production fell 24.2% for retail RRs and 22.3% for institutional RRs! Second, from September 1987 to March of 1988, the number of RRs employed by the "total industry" fell 6.7%, a net loss of 6,439 account executives. This drop was concentrated in the 10 National Full Line firm category (now nine after the Shearson/Hutton merger, which contributed to the employment decline) -- this group's RR workforce dropped 10% over the same period, a loss of 6,150 account executives or 96% of the industry's decline. Employment and compensation changes were uneven across firm categories and will be discussed later in the sections covering each category.

Despite the surge in quarterly profits from 1987 to the first quarter of 1988, we are concerned that these profits were highly concentrated in a relatively small number of firms. As mentioned earlier, we suspected this even before the firm category data became available because of changes in the first quarter revenue sources for the industry (which were available a week earlier). Commission revenues, margin interest revenues, commissions from mutual funds sales, and management fees all plunged from 20-25% during Q1 1988 relative to the quarterly average for 1987. At the same time, trading profits and investment gains rose from $2.5 billion to $3.7 billion. In addition, revenues related to the securities business (such as M&A and private placements) remained vigorous during the first quarter.

These trends suggest that the Large Investment Banking firms and New York City-Based firms, both of whom rely heavily on merchant banking, trading activities and investment positions, dominated the industry's profitability picture during the first three months. In other words, 23% of the firms accounted for 61% of the profits. More dramatically, the LIBs alone, or 2.5% of the firms, accounted for over 43% of the industry's profits. At the same time, firms more heavily dependent on the commission business and the retail customer -- Wirehouses, Regional firms, and Discounters -- felt little relief from the bearish trends and gloom ignited with the market crash of October 19, 1987.

As noted in our last Trends issue, the industry's 1987 results in terms of profit margin and return on equity were at their lowest levels during the 1980s. While revenues inched upwards by 1.5%, total expenses jumped over 11% during 1987. With industry profit margins falling 79% and ROE plunging 83%, no firm category escaped this carnage. However, firm categories which suffered the most during the Q4 crash, for the most part, recovered fastest during Q1 1988, except for the wirehouses.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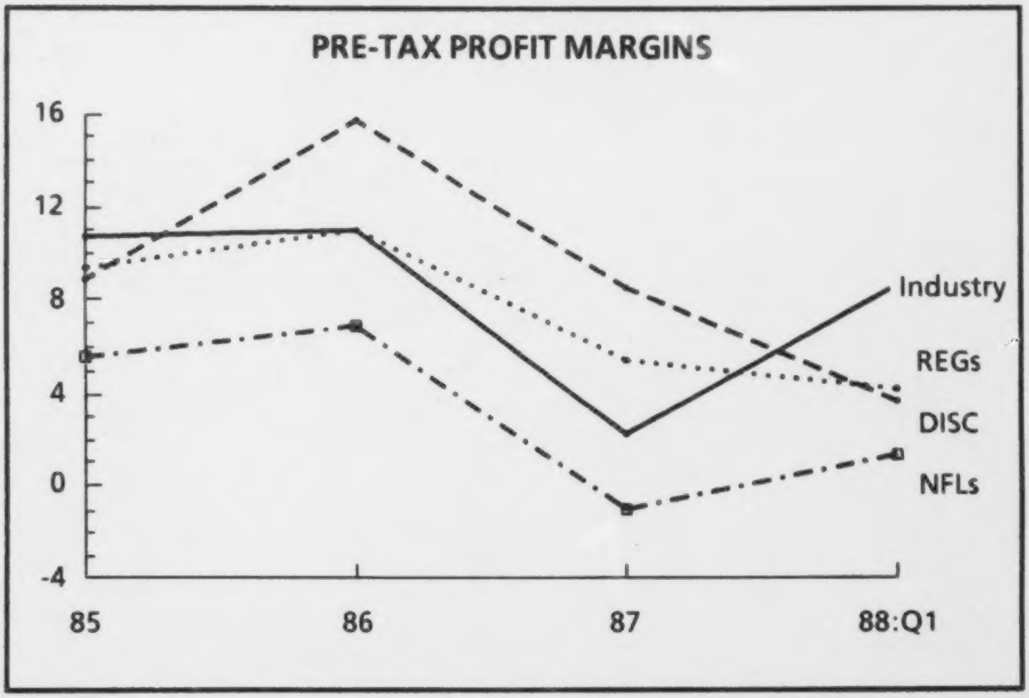
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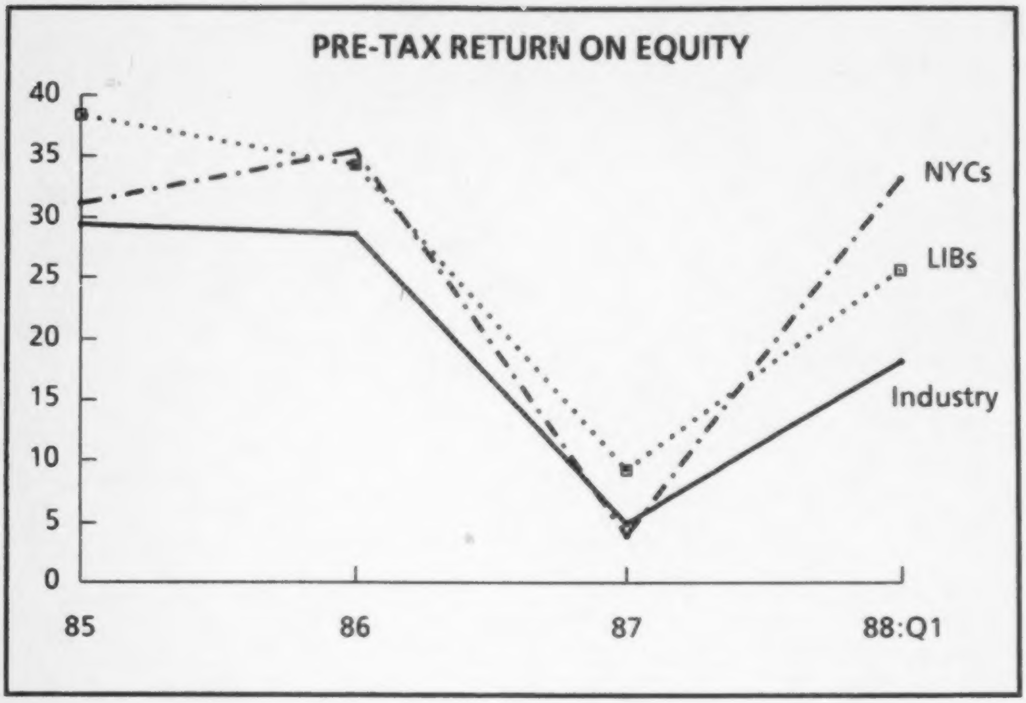
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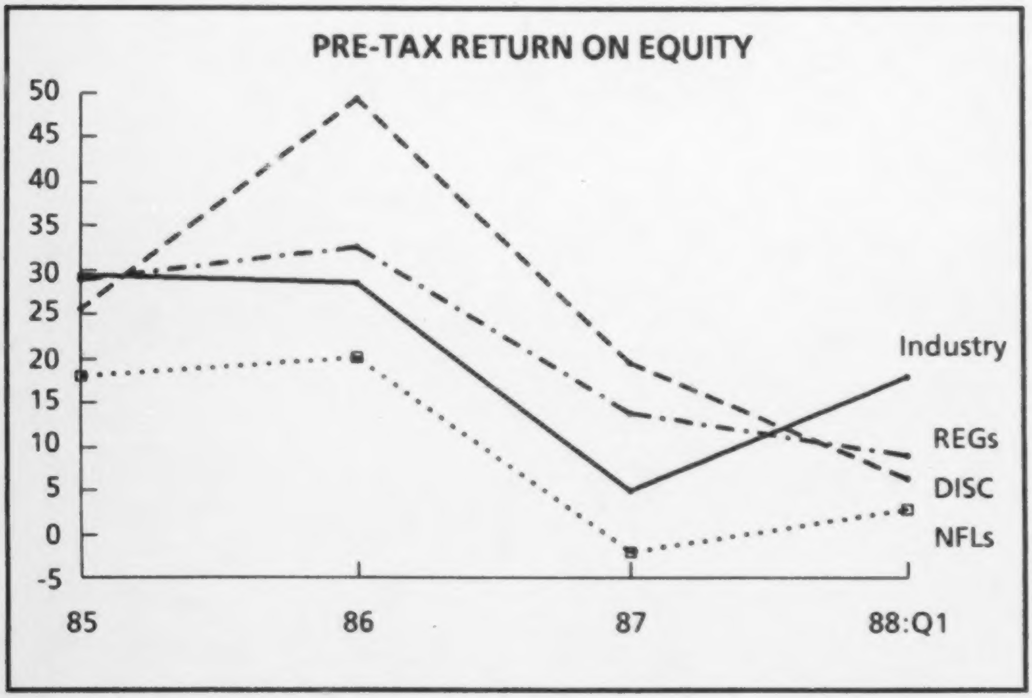
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NATIONAL FULL-LINE FIRMS

The National Full-Line firms lost $193 million in 1987. This group of 10 firms (now nine) are the metro-centers of the retail hemisphere's population -- and it showed. Not only is the post-crash rubble still smouldering, it's smouldering without the benefit of any meaningful previous rebuilding from past disaster years (see Table 3).

Even before (or mostly before) the pre-October quake, the NFLs were having trouble, Last year, revenues dipped 1% and expenses rose over 7% causing their bottom line to plummet from a $1.5 billion pre-tax profit in 1986 to a $200 million loss for 1987. The retail business aftershocks are still being felt -- this year didn't begin much better. The meager $74 million pre-tax profit in the first quarter would net a full-year profit under $300 million. The 10 Large Investment Banks have already booked 65% more than that annual figure in the first quarter alone!

Last year, the NFLs incurred losses despite reining in compensation expenses fairly tightly. RR compensation and clerical and administration salaries rose less than 4% and 1%, respectively. On the other hand, interest expense jumped over 14%. This size increase in their third largest cost component was bound to shatter their bottom line. They must get a better handle on their communications, occupancy and equipment, and promotional and interest costs if they are going to successfully manage their firms through a period of slower revenue growth as in 1987. It appears that management has focused quickly on headcount and compensation in grappling with slower revenue growth. These efforts have to be broadened to other costs as well.

There are some signs that this is happening, particularly with regards to interest expense, as the National Full-Line firms posted a modest $74 million profit during the first quarter of 1988. These firms were able to cut expenses, down 5%, while revenue fell off 2.7% during the first quarter. However, our deep concern remains concerning their ability to manage clerical and administration salaries and occupancy and equipment costs, both of which rose over the 1987 quarterly average. With clerical and administrative salaries usually being their second largest single cost, this expense deserves their careful and prudent attention if the slowdown continues.

For instance, during the first quarter, the NFLs allowed clerical compensation to rise to a record $1.3 billion -- this despite their elimination of over 3,000 clerical jobs since the crash! Further, although the first quarter's RR compensation was the lowest since 1985, a good sign helped by a 10% reduction in their RR workforce since the crash (6,150 jobs) this decline was also helped by lower gross production, which is a two-edged sword. For instance, 1988 Q1 compensation for RRs fell 14% from the 1987 average but commissions in Q1 fell twice as far, down 23% from the 1987 average! These commissions, traditionally the NFLs' prime revenue source (although trading gains have become the #1 revenue source in some recent quarters), came in at an even $1 billion. That's the lowest quarterly level for these firms since 1985! Other bad news also appeared in Q1's upper half of the P&L. Margin interest revenues were the lowest in two years and for mutual funds, only two other quarters (last year's Q3 and Q4) showed lower revenues since 1985.

Although the NFLs are also in the investment banking business and were able to salvage a first quarter profit due to relatively decent underwriting revenues and trading and investment gains, their "other securities related revenue," which would reflect their share of the first quarter's booming M&A and private placement activity, was very weak -- falling back to 1985 levels on an annualized basis. Clearly, these firms prefer "market risk" over "credit risk." They are not that comfortable yet with merchant banking where they lend their own capital on a short-term illiquid basis in the hope of receiving an equity stake in a company where the rewards can, at times, be quite impressive.

Table 3

STATEMENT OF INCOME NATIONAL FULL-LINE FIRMS

(In $ Millions)

Revenues	1986	1987	% Chg.	Quarterly Avg. 1987	88:Q1	% Chg.
Commissions	4,517.0	5,354.3	18.5	1,338.6	1,037.1	(22.5)
Trading Profits	5,513.9	4,414.0	(19.9)	1,103.5	1,419.2	28.6
Investment Gains	20.5	(82.3)	N/A	(20.6)	147.6	N/A
Underwriting	2,947.0	2,475.9	(16.0)	619.0	621.7	0.4
Margin Interest	1,487.1	1,673.9	12.6	418.5	366.8	(12.4)
Mutual Fund Sales	2,024.8	1,579.7	(22.0)	394.9	335.1	(15.1)
Fees, Account Supervision	626.2	748.2	19.5	187.1	141.0	(24.6)
Commodities	737.0	792.2	7.5	198.1	189.4	(4.4)
Other Securities Related	3,652.7	4,232.0	15.9	1,058.0	840.0	(20.6)
Other Unrelated	370.0	495.2	33.8	123.8	175.5	41.8
Total Revenues	21,896.8	21,683.2	(1.0)	5,420.8	5,274.1	(2.7)
Expenses						
RR Compensation	5,498.4	5,698.9	3.6	1,424.7	1,221.9	(14.2)
Clerical Compensation	4,562.4	4,606.5	1.0	1,151.6	1,304.2	13.3
Partner/Officer Comp.	210.1	262.6	25.0	65.7	40.0	(39.1)
Floor (Commission/Clearing)	452.0	560.6	24.0	140.2	108.9	(22.3)
Communications	1,351.4	1,493.4	10.5	373.4	361.4	(3.2)
Occupancy & Equipment	1,235.5	1,531.9	24.0	383.0	404.9	5.7
Promotional Costs	592.6	687.5	16.0	171.9	127.2	(26.0)
Interest Expense	4,006.0	4,576.4	14.2	1,144.1	887.6	(22.4)
Errors/Bad Debts	313.4	630.1	101.1	157.5	81.4	(48.3)
EDP	229.5	252.9	10.2	63.2	62.1	(1.7)
Non-Recurring Charges	45.0	30.1	(33.1)	7.5	6.2	(17.3)
Regulatory Fees	165.5	170.7	3.1	42.7	54.1	26.7
Other	1,715.9	1,373.9	(19.9)	343.5	540.5	57.4
Total Expenses	20,378.0	21,875.8	7.4	5,469.0	5,200.6	(4.9)
Pre-Tax Net Income	1,518.8	(192.6)	(112.7)	(48.2)	73.6	N/A

LARGE INVESTMENT BANKS

The Large Investment Banks, which saw their bottom lines sink into the crash's crevice in Q4 1987, have capitalized on their merchant banking strategic decisions to rebuild and restructure not only corporate America but their own bottom lines.

This strategy, to bet one's capital on the highly risky and volatile merchant banking field, showed its uglier head in the fourth quarter...LIBs posted their first quarterly loss in recent memory. However, risk taking and volatility can eventually pay-off if pockets are deep enough to stay at the table.

But this group's stellar performance (considering the circumstances) in Q1 still didn't recoup all losses. For example, the record $205 million the LIBs lost in their investment accounts in Q4 was not recouped in their impressive $194 million gain in Q1 -- reminiscent of the "house" always wins.

Since the LIBs dominate the "other half" of this split securities world, a little more background on their recent performance (bear in mind that all data in Trends refers to the domestic broker-dealer operations only):

LIBs saw their profit margins drop from 13.5% in 1986 to 4.7% in 1987. In addition, their pre-tax ROE plunged from 34% to just over 9% last year. Their net income recovered smartly during the first quarter of 1988 as revenues expanded by over 11% while costs were rising under 3%. These revenue gains were attributable to impressive performances in their trading and investment positions as well as merchant banking activities. Like every other firm category, their commission business continued to suffer since the October market break as commission revenues and associated activities fell over 25%. Their largest expense category, interest expense, increased only 6% while trading and investment gains were up considerably more. However, their clerical and administrative expenses were up over 16%, which remains a cause for concern given the relatively high ratio of support personnel to producers, as shown in the soon-to-be published SIA/Arthur Andersen Workforce Study.

We feel, however, that the LIBs' compensation increases may be vastly overstated. For some reason, the LIBs' FOCUS data showed a one-time 50% cut in RR and clerical compensation expense in Q4 (back to 1984 levels) which bounced back in Q1! Meanwhile, the LIBs' clerical staff was slashed 10%, or by 2,700 jobs, in the six months since the crash and their smaller (about one-third) RR workforce saw an over 4% reduction during these same six months!

As for the LIBs' largest expense, interest, comprising almost half of their total costs, their ability to keep this expense item from rising near their revenue gains surely helped account for a major portion of the sharp improvement in performance during Q1 1988.

The healthy sphere of the securities business has much to do with the flourishing merchant banking business reflected in the FOCUS lines -- investment gains and revenues related to the securities business. After increasing almost 22% in 1987, merchant banking revenues were up another 17% during Q1 1988. After being scarred by market risk during Q4 1987, the LIBs, in particular, have embraced merchant banking, or credit risk instead. The market treated these firms harshly in 1987 not only because of the October 19 crash which saw the DJIA down 36% from its August peak but because of losses sustained in the fixed income markets, where Treasuries plunged 26% between 3/27/87-10/19/87.[1]

After such a scarring, it is no wonder that the LIBs and other firms have turned to merchant banking. After all, during Q1 1988, $39.5 billion of takeovers were completed (217 deals for more than 50% of a company) while $133.9 billion (432 deals) were announced compared to $31.4 billion of M&A deals completed and $65.6 billion announced during Q1 1987.[2] The M&A fever is being pushed by: (1) post-crash "cheap" stock prices; (2) foreign takeovers stimulated by the cheap dollar; and (3) a desire to complete deals while the current Administration is in power.

So far, these activities have, for the most part, been gold mines. One word of caution: asset values vary according to the economic cycle. A recession will change the LBO outlook dramatically as asset values fall while the debt remains. However, we have remained more optimistic about the economy than many other observers since October. The prices being paid for companies is about the same as before Black Monday while stocks are trading about 25% below the 1987 high. Something has to give and we know there is no such thing as a "free lunch." We remain cautious about the LBO fever and worried about whether these activities become the bad loan headaches of tomorrow.

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[1] The Economist, "America's Capital Markets," June 11-17, 1988, p. Survey, 6.

[2] Securities Data Co.

Table 4

STATEMENT OF INCOME
LARGE INVESTMENT BANKS

(In $ Millions)

Revenues	1986	1987	% Chg.	Quarterly Avg. 1987	88:Q1	% Chg.
Commissions	1,439.2	1,816.1	26.2	454.0	339.0	(25.3)
Trading Profits	5,152.1	3,830.5	(25.7)	957.6	1,084.8	13.3
Investment Gains	522.6	95.3	(81.8)	23.8	193.9	714.7
Underwriting	1,967.9	1,814.0	(7.8)	453.5	409.0	(9.8)
Margin Interest	483.2	610.3	26.3	152.6	101.3	(33.6)
Mutual Fund Sales	51.0	39.7	(22.2)	9.9	5.6	(43.4)
Fees, Account Supervision	307.9	352.9	14.6	88.2	75.3	(14.6)
Research	22.4	1.0	(95.5)	0.3	0.0	--
Commodities	235.7	197.2	(16.3)	49.3	146.6	197.4
Other Securities Related	3,883.4	4,727.9	21.7	1,182.0	1,388.2	17.4
Other Unrelated	1,195.1	1,289.2	7.9	322.3	358.8	11.3
Total Revenues	15,260.5	14,774.2	(3.2)	3,693.6	4,102.4	11.1
Expenses						
RR Compensation	1,532.6	1,437.5	(6.2)	359.4	355.5	(1.1)
Clerical Compensation	1,918.7	2,172.0	13.2	543.0	632.5	16.5
Partner/Officer Comp.	522.9	599.5	14.6	149.9	175.7	17.2
Floor (Commission/Clearing)	327.2	478.8	46.3	119.7	108.1	(9.7)
Communications	394.0	444.5	12.8	111.1	101.0	(9.1)
Occupancy & Equipment	416.0	554.6	33.3	138.7	164.3	18.5
Promotional Costs	204.8	241.3	17.8	60.3	46.1	(23.5)
Interest Expense	6,434.6	6,735.8	4.7	1,684.0	1,785.2	6.0
Errors/Bad Debts	42.7	168.8	295.3	42.2	5.1	(87.9)
EDP	200.9	253.7	26.3	63.4	63.3	0.2
Non-Recurring Charges	18.8	59.2	214.9	14.8	3.8	(74.3)
Regulatory Fees	50.3	41.4	(17.7)	10.4	8.1	(22.1)
Other	1,129.8	894.9	(20.8)	223.7	167.3	(25.2)
Total Expenses	13,193.2	14,081.6	6.7	3,520.4	3,616.0	2.7
Pre-Tax Net Income	2,067.3	692.6	(66.5)	173.2	486.4	180.8

NEW YORK CITY-BASED FIRMS

From earlier analyses, we have found the New York Based firm category to be a heterogenous grouping. In some ways, they are microcosms of the Large Investment Banks; that is, much more dependent on trading and investment profits and merchant banking than other segments of the industry. Because they are so heavily dependent on trading, investment, and merchant banking activities, this category suffered grievously during Q4 1987. This was reflected in the sharp deterioration in 1987 of their pre-tax profit margin and ROE relative to 1986.

In fact, their fourth quarter losses in investments (a FOCUS revenue line which can, and did, read in the negative) reached $447 million -- which halved their Q4 total revenues down to $437 million. That translated into a 70% drop in revenues from the NYCs' third quarter -- the closest we've seen to a group of firms posting zero or negative revenues and a milestone in highlighting the principle business' risk and volatility!

However, the NYCs' net income exploded during the first quarter of 1988, increasing from an average quarterly profit of $24.5 million in 1987 to over $200 million during the first quarter. Despite a revenue increase of 15% relative to the average quarter last year, these firms were able to cut costs by 1%. Their profitability turnaround was due to the change in investment gains. Whereas they lost on average over $19 million per quarter during 1987, they earned over $190 million during Q1 1988 alone. Also, "revenues related to the securities business" increased 20% over the average for 1987 and hit an all-time high of over $400 million, reflecting the first quarter's booming M&A advisory business which the NYCs are actively involved in.

Interestingly, this group of firms had net employment hirings of around 5% for producers and non-producers alike since the crash. There was a choice pool of securities professionals to choose from while these firms were building their 1988 business. Furthermore, their compensation expenses held about even despite additions to their workforce.

Like other firm categories, the NYCs' revenues from the commission business tumbled more than 25% during the first quarter of 1988 relative to the quarterly average of 1987.

The key to their first quarter improvement lies in their trading and investment strategies. As trading revenues increased more than 46% and investment profits went from a negative $19 million to a positive $190 million, interest expense went up only 4% in the first quarter relative to the quarterly average during 1987. With securities related, i.e., merchant banking activities up 20% during Q1 1988 relative to 1987, these firms remain unscathed from the dismal commission and other retail market segments of the industry suffering this year. As mentioned, this category's dependence on merchant banking and trading activities was reflected in the volatile and sharp deterioration in their 1987 performance relative to 1986. Of all the firm categories, this group suffered the most from the carnage of the last quarter of 1987 while benefitting the most from rising security prices and a flourishing M&A environment during Q1 1988.

Table 5

STATEMENT OF INCOME
NEW YORK CITY-BASED FIRMS

(In $ Millions)

Revenues	1986	1987	% Chg.	Quarterly Avg. 1987	88:Q1	% Chg.
Commissions	1,294.0	1,561.5	20.7	390.4	291.7	(25.3)
Trading Profits	685.1	621.0	(9.4)	155.3	227.8	46.7
Investment Gains	130.5	(77.3)	(159.2)	(19.3)	190.7	N/A
Underwriting	184.8	116.9	(36.7)	29.2	20.2	(30.8)
Margin Interest	166.0	207.8	25.2	52.0	34.4	(33.8)
Mutual Fund Sales	52.4	37.6	(28.2)	9.4	5.2	(44.7)
Fees, Account Supervision	253.2	339.4	34.0	84.9	64.2	(24.4)
Research	10.1	5.1	(49.5)	1.3	0.6	(53.8)
Commodities	10.8	11.8	9.3	3.0	6.3	110.0
Other Securities Related	965.1	1,340.4	38.9	335.1	402.0	20.0
Other Unrelated	87.3	372.1	326.2	93.0	60.2	(35.3)
Total Revenues	3,839.2	4,536.6	18.2	1,134.2	1,303.8	15.0
Expenses						
RR Compensation	478.4	527.3	10.2	131.8	152.5	15.7
Clerical Compensation	565.8	743.7	31.4	185.9	171.6	(7.7)
Partner/Officer Comp.	141.2	150.7	6.7	37.7	33.8	(10.3)
Other Compensation	186.0	210.8	13.3	52.7	27.4	(48.0)
Floor (Commission/Clearing)	243.2	325.9	34.0	81.5	68.2	(16.3)
Communications	121.3	145.0	19.5	36.3	37.8	4.1
Occupancy & Equipment	132.8	178.0	34.0	44.5	61.6	38.4
Promotional Costs	60.9	75.9	24.6	19.0	18.8	(1.1)
Interest Expense	849.5	1,503.6	77.0	375.9	392.0	4.3
Error/Bad Debts	13.4	28.9	115.7	7.2	3.9	(45.8)
EDP	36.8	58.1	57.9	14.5	13.9	(4.1)
Non-Recurring Charges	4.5	7.8	73.3	2.0	0.1	(95.0)
Regulatory Fees	28.3	31.1	9.9	7.8	7.8	--
Other	357.4	451.8	26.4	113.0	109.0	(3.5)
Total Expenses	3,220.8	4,438.6	37.8	1,109.7	1,098.4	(1.0)
Pre-Tax Net Income	618.4	98.0	(84.2)	24.5	205.4	N/A

REGIONAL FIRMS

The bulk of retail land, outside of the NFLs' mega-metro center, is made up of the Regional firms. Highly reliant on the retail client, this large group of firms accurately reflects the suffering half of the split securities world.

The Regionals' profitability picture continued to be distressing. Although almost any environment would be better than the fourth quarter of last year, the Regional firm community earned only $45 million before taxes during Q1 1988. This was a decrease of one-third from the quarterly average of 1987. Even more distressing, if last year's fourth quarter loss is disregarded (which is hard to do), this year's first quarter profit was the lowest for the Regionals since 1985's second quarter -- and that's not even inflation adjusted!

With quarterly revenues plunging 14.5%, the Regional firm community found it difficult to cut costs at the same pace, although they made impressive strides in attempting to do so. Costs were down over 13% compared to the quarterly average for 1987.

Customers of the Regional firm community remain paralyzed because of the events during last October. Commission revenues, underwriting, and commissions from mutual fund sales in particular, plummeted during the first quarter as compared to 1987. Commissions were down about 25% or more (again, the lowest level since 1985) while mutual fund sales revenues were down over 40%, virtually tied with Q4's disastrous level, the lowest since 1985's first quarter. In underwriting, as with mutual funds, 1987's Q4 and 1988's Q1 underwriting levels were the worst since Q1 1985.

Fortunately, the managements of Regional firms have moved quickly in curbing costs so as to remain viable. As is the case with other firm categories, RR compensation, clerical and administrative salaries, and interest expense are the three largest cost factors. All three expense items declined in the first quarter relative to the average quarter last year, but only RR compensation fell at a pace quicker than the decline in revenues. In this case, however, RR comp's fall cannot be attributed to a pared-back workforce. As a group, Regionals showed a 2% net increase in producers (although the body count was up merely 300 people and in the clerical area, 700 jobs, or 3%, were pared back). The cut in RR expense was entirely due to severely lower gross production. SIA's "Production and Earnings of RRs" report showed average retail RR production down about 24% but particularly devastating at the smaller Regionals. Those with 50 to 100 RRs saw their retail RR's average gross production fall 60% in the six months since the crash!

Coming on top of the $62 million loss during the fourth quarter of last year, morale at the Regional firms remains depressed. Nevertheless, cost reductions of 13% during the first quarter of 1988 relative to quarterly expenses last year are nothing to sneeze at in terms of managerial accomplishment. When the revenue turnabout does occur, the Regional firms should be immediate beneficiaries as they have pared their costs back substantially.

This cost flexibility has been important to the Regional firm community. Despite suffering the consequences of the disastrous Q4 1987 like everybody else, these firms fared better than the industry average during 1987. Their pre-tax profit margin of 5.5% and ROE of 14.1% during 1987 compared favorably to the "industry's" results.

The trauma of October 19 and its aftermath remains ingrained in the memories of the Regional firm community and their customers. It may be some time before their customer base decides to jump into the market again as investors or issuers. This being the case, the trick is to keep costs down and push other products while boosting morale of the salesforce. The plunge in commissions and associated activities is an ominous trend for these firms. Their greatest danger lies in a protracted bear market with customers simply losing interest in "core" financial products.

However, time is on the side of the Regionals. Eventually, people forget the last trauma and recognize good value. The economy's performance over the last eight months warrants confidence, particularly in light of reduced international tensions, both economic and military. Moreover, during the next 15 years, the 45-65 age group in the U.S. will increase by 7.7 million individuals compared to a 1.1 million increase over the last 10 years.3/ Such a dramatic increase in the largest savings group represents a vast potential market for firms focusing on the retail investor.

3/ The Economist, "America's Capital Markets," June 11-17, 1988, p. Survey, 27.

Table 6

STATEMENT OF INCOME
REGIONAL FIRMS

(In $ Millions)

Revenues	1986	1987	% Chg.	Quarterly Avg. 1987	88:Q1	% Chg.
Commissions	1,642.7	1,813.0	10.4	453.3	338.6	(25.3)
Trading Profits	929.5	819.8	(11.8)	205.0	246.5	20.2
Investment Gains	47.7	37.3	(21.8)	9.3	26.9	189.2
Underwriting	711.4	629.2	(11.6)	157.3	117.9	(25.0)
Margin Interest	277.7	314.0	13.1	78.5	63.1	(19.6)
Mutual Fund Sales	659.5	533.3	(19.1)	133.3	76.6	(42.5)
Fees, Account Supervision	86.9	107.8	24.1	27.0	23.8	(11.9)
Research	9.2	10.2	10.9	2.6	5.0	92.3
Commodities	46.1	48.9	6.1	12.2	12.8	4.9
Other Securities Related	461.7	531.7	15.2	132.9	123.7	(6.9)
Other Unrelated	95.3	117.1	22.9	29.3	25.8	(11.9)
Total Revenues	4,967.4	4,960.7	(0.1)	1,240.2	1,060.8	(14.5)
Expenses						
RR Compensation	1,422.2	1,405.7	(1.2)	351.4	272.8	(22.4)
Clerical Compensation	881.0	915.1	3.9	228.8	219.0	(4.3)
Partner/Officer Comp.	335.6	313.6	(6.6)	78.4	65.7	(16.2)
Other Compensation	86.2	139.1	61.4	34.8	34.1	(2.0)
Floor (Commission/Clearing)	228.3	230.4	0.9	57.6	48.5	(15.8)
Communications	307.0	327.9	6.8	82.0	77.0	(6.1)
Occupancy & Equipment	248.5	267.4	7.6	66.9	67.8	1.3
Promotional Costs	125.7	137.6	9.5	34.4	31.4	(8.7)
Interest Expense	330.3	396.7	20.1	99.2	88.6	(10.7)
Error/Bad Debts	34.6	83.4	141.0	20.9	6.9	(67.0)
EDP	75.0	82.5	10.0	20.6	19.9	(3.4)
Non-Recurring Charges	2.3	2.0	(13.0)	0.5	1.2	140.0
Regulatory Fees	37.2	43.4	16.7	10.9	8.7	(20.2)
Other	307.4	341.6	11.1	85.4	74.1	(13.2)
Total Expenses	4,421.3	4,688.1	6.0	1,172.0	1,015.7	(13.3)
Pre-Tax Net Income	546.1	272.6	(50.1)	68.1	45.2	(33.6)

DISCOUNTERS

The Discount category also suffered a deterioration in profitability during Q4 1987. Their pre-tax profit margin plunged from 15.7% in 1986 to 8.6% in 1987. Meanwhile, because of the limited amount of capital required to do a discount business, their pre-tax ROE, although dropping from 49.5% in 1986 to 19.7% in 1987, remained the highest of all the firm categories.

Surprisingly, the Discount firms were "way off the board" in terms of trends in total revenues and total expenses compared to the other firm categories. Whereas industry revenues rose 1.5% from 1986 to 1987, the revenues of the Discounters increased almost 40% last year. More interestingly, as the industry's expenses rose over 11% during 1987, the costs of the Discount category almost increased by 50% from 1986 to 1987; yet, their pre-tax ROE remained at close to 20% during 1987. Surprisingly, the Discounters appeared lax in almost every expense category as they anticipated continued expansion in their business.

Losses in error accounts and bad debts skyrocketed for the industry in October. DKs and unmet margin calls plagued the industry that month, although given the unprecedented 600 million share days and the biggest market crash ever, things went rather smoothly. For the Discounters, this loss/error line went from an average of $1-$2 million per quarter to a record $61.3 million in the fourth quarter. That effectively reversed what would have been a profit of $22 million into a loss of $39.3 million (although a good part of this loss is probably due to one well-publicized loss in a single account at one discounter).

Literally every expense item increased by at least 20% relative to the previous year. With commissions, margin interest revenues, and commissions from mutual fund sales all increasing by 30% or more, the Discounters took a very optimistic view about future business trends and were busy adding staff and equipment to handle what seemed like an endless upsurge in retail customers using Discounters to handle their increased activity.

Naturally, Q4 1987 changed these trends. Whereas revenues and costs were both rising sharply in 1987, these variables changed direction suddenly during Q1 1988. Revenues plunged over 17% relative to the average quarter during 1987 while costs were cut almost 13%. Commission revenues fell over 25% while margin interest revenues fell over 16%. Because these two revenue items comprise about 70% of the total revenues of the Discount category, total revenues plunged over 17%.

The Discounters made a valiant attempt to cut costs in order to counter their falling revenues. Although expenses were reduced almost 13% (after increasing 50%), pre-tax net income fell by nearly two-thirds relative to the quarterly average for 1987. The Discounters reacted quickly by reducing expenses related to compensation, except for RR compensation (+27%) and clerical and administrative salaries which surprisingly increased by 2%.[4] Also, like other firms, they had trouble controlling their occupancy and equipment costs, possibly because of commitments made in earlier periods, as these expenses rose 20% while revenues were falling 17%. Like the Regionals, given the interruption of their basic business, commissions and revenues from margin accounts, the immediate future looks bleak for Discounters. If the doldrums continue in the retail market, they will have to make further tough decisions concerning clerical and administrative positions as well as occupancy and equipment costs to restore profitability to healthier levels.

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[4] Although it contradicts the layoffs/hiring freezes announced by the Discounters, their FOCUS data showed a net gain of 35 producers (up 3.3%) and 366 non-producers (up 11.4%) or a total headcount increase of 401 people (up 9.4%) in the six months since the crash.

The languishing and depressed retail and commission business is reflected in the profit margins of the Discounters. After pre-tax profit margins of 15.7% in 1986, their profit margin fell to 8.6% in 1987 and only 3.8% during Q1 1988. The Q1 1988 figure was the lowest since 1984 and the second lowest of the time periods we have recorded since the 1980s. Likewise, their pre-tax ROE tumbled to 6.4% during Q1 1988.

In the past, Discounters have enjoyed pre-tax ROEs higher, in general, than the industry. Despite the disastrous fourth quarter, the Discounters still earned a pre-tax ROE almost four times that of the total industry. However, this was not the case for Q1 1988 when their pre-tax ROE was less than one-half that of the industry's 18.1%. Except for the wirehouses, the Discounters had the lowest ROE among all the firm categories. Unless the retail market turns around, these firms will continue to suffer and will have to cut expenses or diversify their product base further, if they hope to survive the market doldrums.

Table 7

STATEMENT OF INCOME
NYSE DISCOUNTERS

(In $ Millions)

Revenues	1986	1987	% Chg.	Quarterly Avg. 1987	88:Q1	% Chg.
Commissions	539.2	717.5	33.1	179.4	133.1	(25.8)
Trading Profits	9.7	5.5	(43.2)	1.4	1.8	28.6
Investment Gains	6.8	(0.7)	(110.3)	(0.2)	3.7	N/A
Margin Interest	148.2	192.4	29.8	48.1	40.2	(16.4)
Mutual Fund Sales	8.7	11.4	31.0	2.9	3.2	10.3
All Other	180.9	304.3	68.2	76.1	73.0	(4.1)
Total Revenues	893.5	1,230.4	37.7	307.6	255.0	(17.1)
Expenses						
RR Compensation	23.1	28.1	21.6	7.0	8.9	27.1
Clerical Compensation	112.0	140.4	25.4	35.1	35.8	2.0
Partner/Officer Comp.	16.8	21.8	29.8	5.5	3.5	(36.4)
Other Compensation	50.5	117.6	132.9	29.4	28.3	(3.7)
Floor (Commission/Clearing)	140.5	171.0	21.7	42.8	29.0	(32.2)
Communications	43.2	52.9	22.5	13.2	13.0	(1.5)
Occupancy & Equipment	41.8	58.5	40.0	14.6	17.5	19.9
Promotional Costs	22.9	29.9	30.6	7.5	5.4	(28.0)
Interest Expense	120.9	167.1	38.2	41.8	43.4	3.8
Error/Bad Debts	7.0	66.7	852.9	16.7	1.3	(92.2)
EDP	40.8	55.6	36.3	13.9	7.7	(44.6)
Regulatory Fees	4.4	4.3	(2.3)	1.1	1.5	36.4
Other	129.1	210.7	63.2	52.7	50.0	(5.1)
Total Expenses	753.1	1,124.9	49.4	281.2	245.3	(12.8)
Pre-Tax Net Income	140.4	105.5	(24.9)	26.4	9.6	(63.6)

CONCLUSION

The post-crash securities industry is becoming more and more a split world -- retail vs. trading/investment banking. While October's quake didn't create the fissure, in its aftermath we can clearly see the trading/investment banking world spinning along on its merchant banking-based axis while the retail world has almost ground to a halt. A dramatic view of how the industry has changed -- the securities industry generated more than half its total revenues from commissions just over a decade ago but only 18.6% of its Q1 1988 revenues dribbled in from this source. With only about two thirds of those commissions being retail-driven, retail activity remaining at anemic levels this year, and retail-oriented firms extremely dependent on these commissions, Regionals, Discounters and National Full Line firms are in for some further tough sledding.

Also, all those wonderful merchant/investment banking, trading and investment gains which helped the institutional houses in the first quarter must be remembered for what they are -- risky and volatile. It was these same revenue sources which were the most battered in last year's fourth quarter.

However, all is not bleak. Securities firms' management learned some valuable lessons from the past. They have moved more quickly than in the past to reduce costs when faced with a revenue slowdown. For example, the last comparable period in terms of a slowdown was in 1984 when revenues rose slightly over 5% on an annual basis. In that same year, however, costs rose over 15% or almost three times as fast. Moreover, they are always challenged by sudden surges in volume and abrupt slowdowns in activity.

In 1986, volume on the NYSE surged 29% over 1985. One year later, average daily volume exploded by 34% from the previous year and day-to-day changes were even more dramatic. Meanwhile, through the first four months of 1988, volume on the NYSE lagged that from last year by more than 7%, even including the accelerated level of corporate buybacks and dividend recapture programs that have taken place. Given such turbulent changes and the variety of external shocks that affect the securities markets, it requires a delicate and, most importantly, quick reacting and fast moving management team to cope with ever-increasing volatile market conditions.

The securities industry has weathered other activity and profit droughts and this time management has moved swiftly to control the expenses they had let run away during the bull market. If the risk management strategies which were initiated after October are broadened and tightened, management may be able to better control the downside in its risk-capital targeted endeavors of the future. If management can also refrain from future runaway growth (that does not mean not to build during bull markets - that would be foolishly letting opportunity - spelled profits - slip away), but keep growth and costs at reasonable levels relative to revenues and profits and risk, the inevitable next bull (and next bear) can be a better time for all.

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APPENDIX A

In issues of Trends, SIA analyzes the financials of the "total securities industry" as well as firm category components. The "total industry" is actually a proxy for the total industry -- it is the New York Stock Exchange (NYSE) member firms which do a public business. SIA and the NYSE maintain a joint database (available to members of either organization) which updates the financials of these groups of firms on a timely, quarterly basis. The data are derived from the regulatory FOCUS (Financial and Operational Combined Uniform Single) Report filed with the NYSE.

As the table below shows, this group of firms, although small in number when compared to all broker-dealers reporting to the Securities & Exchange Commission (SEC), still account for the vast bulk of securities business done in the U.S. Even with the number of all firms reporting to the SEC doubling since 1979, and the NYSE group remaining around 400 firms (395 at year-end 1987 and 393 on March 31, 1988), the NYSE group has maintained its dominance of the financials. Also, as the table below indicates, all firm data (available only annually) is released quite late -- this issue of Trends covers the NYSE group's performance through the first quarter of 1988, while the SEC will be releasing 1987 results in late August -- another reason for using this NYSE group as a proxy for the industry.

NYSE GROUP'S SHARE OF TOTAL INDUSTRY*

(Percent)

Item	79	80	81	82	83	84	85	86
Revenues	80	80	81	81	80	81	77	77
Assets	84	85	78	86	85	88	86	86
Capital	66	65	66	70	72	71	70	71
Equity	63	63	65	69	71	69	68	69
# of Firms								
NYSE Group	374	389	390	387	412	393	381	417
All Firms	4,824	5,283	5,714	6,165	7,429	8,298	8,766	9,328

*Total industry based on data from the SEC Monthly Statistical Review, August 1987.
NYSE Group: New York Stock Exchange member firms doing a public business.

APPENDIX B

The bulk of the securities business done in the U.S. is handled by a group of about 400 NYSE member firms which deal with the public, or less than 5% of all reporting broker-dealers. Within this NYSE group, the bulk of business is also concentrated. For instance, the 25 largest NYSE firms (calculated quarterly by firm capital size) account for about three-quarters of the NYSE group's revenues and capital (see table below) while, as we've seen on the previous page, the NYSE group accounts for over three-quarters of all firms' revenues and over 70% of all firms' capital.

While this indicates a highly concentrated securities industry, the data indicates that, at least at present, the concentration has peaked. The NYSE group's share of all firms' revenues reached its highest point (81%) in 1981-82 and its share of capital (71%) in 1983, although the NYSE group remained around 400 firms while all firms doubled in the Eighties! For the 25 largest capitalized firms, their share of the NYSE group's revenues and capital peaked in 1985 at 77% and 78%, respectively.

SECURITIES INDUSTRY CONCENTRATION*

Total Revenues	80	81	82	83	84	85	86	87	88**
Top 10	53.1%	55.6%	57.3%	54.4%	58.8%	57.5%	57.3%	54.5	54.2
Top 11-25	19.4	18.7	18.7	19.6	17.1	19.7	19.8	21.1	20.8
Rest of Industry	27.5	25.7	24.0	26.0	24.1	22.8	22.9	24.4	25.0
	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
Revenues ($ Bils.)	16.0	19.8	23.2	29.6	31.2	38.6	50.1	50.8	13.0
Total Capital									
Top 10	50.8%	50.0%	54.8%	52.8%	57.2%	63.2%	61.9%	58.8	59.1
Top 11-25	18.0	19.7	18.3	18.8	15.6	14.8	16.0	18.7	17.3
Rest of Industry	31.2	30.3	26.9	28.4	27.2	22.0	22.1	22.5	23.6
	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
Capital ($ Bils.)	6.7	8.1	10.7	14.2	16.7	21.9	29.8	35.4	36.3

* NYSE Group.
**First Quarter.

VOLUME

	MAR 1988	Q1 1988	MAR 1987	Q1 1987	% CHAN Q1 1988-1987
AVERAGE DAILY SHARE VOLUME ON					
NYSE (MILS.)*	176.2	178.6	180.3	185.6	-3.8%
AMEX (MILS.)*	12.4	10.8	15.7	15.2	-29.0%
NASDAQ (MILS.)*	137.3	128.6	151.0	154.4	-16.7%
REGIONAL EXCHANGE (MILS.)*	24.9	28.0	28.0	28.4	-1.3%
DOLLAR VALUE OF SHARES TRADED ON					
NYSE (MILS.)	$134,828	$371,533	$166,316	$472,549	-21.4%
AMEX (MILS.)	3,681	8,432	5,441	15,150	-44.3%
ODD-LOT SHARES PURCHASED ON NYSE (THOUS.)	8,093	22,552	12,442	34,004	-33.7%
ODD-LOT SHARES SOLD (INCLUDING SHORT SALES) ON NYSE (THOUS.)	18,027	44,783	21,236	57,475	-22.1%
NYSE BLOCK VOLUME AS A PERCENT OF TOTAL SHARES TRADED	52.8%	51.7%	52.9%	51.2%	----
CONTRACTS TRADED (THOUS.)					
CBOE OPTIONS	9,850	27,130	16,723	51,460	-47.3%
AMEX OPTIONS	3,841	9,505	4,522	13,299	-28.5%
COMMODITY	20,636	58,578	16,657	48,663	20.4%

*MONTHLY AVERAGE
N/A - DATA NOT AVAILABLE

UNDERWRITING

	FIRST QUARTER 1988	FIRST QUARTER 1987	% Change 1988--1987
CORPORATE FINANCING (Gross New Issues - $ Mils)			
TOTAL	$67,967.1	$89,509.0	-24.1%
Common Stock	$7,732.0	$11,943.2	-35.3%
# of Common Stock Issues	68	208	-67.3%
Preferred Stock	$2,260.5	$4,006.9	-43.6%
# of Preferred Stock Issues	38	53	-28.3%
Corporate Debt	$57,974.6	$73,558.8	-21.2%
# of Corporate Debt Issues	683	690	-1.0%
MUNICIPAL FINANCING (Gross New Issues - $ Mils)			
Negotiated	$17,855.0	$26,580.5	-32.8%
# of Issues	602	957	-37.1%
Competitive	$6,334.5	$5,703.6	11.1%
# of Issues	617	855	-27.8%

YIELDS

(MONTHLY AVERAGES)

	MAR 1988	MAR 1987	BASIS POINT CHG 1988-1987
BOND BUYER INDEX (20 BOND)	7.74%	6.66%	108
CORPORATE BOND YIELDS (MOODY'S)			
Aaa CORPORATE	9.39	8.36	103
Baa CORPORATE	10.57	9.61	96
RATIO Aaa CORPS. TO Baa CORPS.	0.89	0.87	2

PRICES
(END OF MONTH)

	MAR 1988	MAR 1987	% CHAN MAR 1988-1987
DOW JONES INDUSTRIALS	1988.06	2304.69	-13.74%
STANDARD & POOR'S 500	258.89	291.70	-11.25%
NYSE COMPOSITE	146.60	165.89	-11.63%
AMEX MARKET VALUE INDEX	296.43	332.66	-10.89%
VALUE LINE COMPOSITE	228.14	267.88	-14.84%
NASDAQ COMPOSITE	374.64	430.05	-12.88%

RECENT INTERESTING READING AND STATISTICAL MATERIAL

Item	Description	Source
Production & Earnings of RRs	SIA's fifteenth annual survey. Based on data from 49 SIA member firms, 85-page report provides detailed information on: gross production of retail and institutional RRs, payout percentage, ticket sizes and branch manager earnings. Data presented by firm size classifications. Special "flash" report also compares 1987 production and earnings with the November 1987 through April 1988 period. Comparing these two periods shows retail gross production down 24.2% and institutional production off 22.3%.	William Jordan SIA $500 SIA members/ $1,200 other
Capital Gains Studies	**"The Direct Revenue Effects of Capital Gains Taxation."** Authors examine actual experience through 1985 and conclude: 1. the 1978 act produced large and continuing direct revenue gains; 2. estimates of losses from the 1981 act were dramatically overstated, and 3. both acts were significantly revenue-enhancing.	Treasury Bulletin Spring Issue June 1988
	"CBO Works on Capital Gains." Summary of the study which presents new estimates of the behavioral response to changes in tax rates on capital gains. Although significant, this response is not sufficient to generate higher revenues from lowering the tax rate on capital gains to 15%.	Tax Notes 6/20/88
	"The New Treasury Capital Gains Study: What is the Black Box?" Author Minarik disputes analysis and methodology used in the Treasury study.	
"The Globalization of Financial Markets"	Authors examine the nature of the linkages of world financial markets and the strategic implications of the global relationships for various players in the new kind of marketplace. The authors argue for the need to think beyond cross-border flows of capital to a broadly integrated, large but single marketplace.	The McKinsey Quarterly Winter 1988

Item	Description	
"Power Investors"	Article reports on a new industry trend. By pooling a firm's own money with pension funds and other institutions, Street firms are becoming outright owners of major companies. "Power investors" differ in two respects from the traditional LBO artists: focus is not solely on equity investing but providing a multitude of other fee-based services and time horizon is long- not short-term. Business in the 1990s may well be based on a firm's major stake in their clients, not just on the traditional investment-banking relationship.	Business Week 6/20/88
"America's Capital Markets"	Will the stock market crash in October follow the 1929 pattern or be a harbinger of a slump? Survey of 18-pages examines various facets of the current state of the U.S. capital markets from the British point of view. Concludes last October was not a freak but rather a warning of a deflationary tempest ahead. The repeat of a long, slow bear market would do more damage to the securities industry than would 20 crashes, as liquidity contracts and more people simply lose interest in the financial markets.	The Economist June 11-17
"Corporate Buyers Beat Anti-Takeover Defenses in 1988"	Corporate acquirers with deep pockets have shattered traditional takeover defenses consistently in 1988, prompting some M&A pros to claim traditional defense strategies no longer work in today's changing game. Pros say the best defense for a company faced with a hostile bidder is to find a white knight who will pay an even higher price than a hostile bidder. Reviews defense records of four major firms.	Investment Dealers' Digest 6/13/88
"The Rewiring of Hutton"	The task of completing Wall Street's biggest merger fell to Shearson's data shop. The philosophy as well as the "how to's" of Shearson's senior executive VP and co-chief administrative officer on the back office side of the merger are presented in this article.	Institutional Investor June 1988

8/16/88

Securities Industry
Trends
AN ANALYSIS OF EMERGING TRENDS IN THE SECURITIES INDUSTRY
Produced by the SIA Research Department

Vol. XIV, No. 4 August 1, 1988

DISCOUNTERS' DOLDRUMS

The number thirteen has turned out to be very unlucky for the discount brokerage business. It has been that many years since "May Day," when mandatory fixed-rate commissions were abolished, and discounters, as well as other brokerages relying on the retail customer, are now struggling in an anemic environment. Although discounters' P&Ls are still in the black, they are using a lot less ink to pen their bottom line.

Highlights

1. Discounters' pre-tax returns on equity, once the best in the industry, fell from 50% in 1986 to 20% last year to a razor thin 6% in this year's first quarter.

2. After a decade of rising market share in industry commissions, revenues, profits and retail commissions, the discounters' slice of these pies shrank in the first quarter, and that's out of much smaller pies to begin with.

3. Although last October's huge equity volumes helped boost discounters' commissions and revenues, their quarterly losses on bad debts and errors jumped from a normal $1-$2 million to over $60 million, causing a probable $20 million profit to become a $40 million-plus loss.

4. The outlook for retail commissions, a full three-fifths of discounters' total revenues, has worsened as the year progressed. New York Stock Exchange retail "activity" (both sales and buys) peaked with October's 183 million shares per day but crashed to only 86 million per day in the first quarter. Worse, still, it cascaded further to only 80 million per day in May!

5. Business concentration among the discounters continues. The 26 NYSE discounters, including all the large national discounters, captured 85% of all discounters' commissions and revenues last year and 90% of all discounters' profits; these concentration ratios set new records.

INTRODUCTION

This issue of Trends is an update of two prior issues dealing exclusively with discount brokers: Trends, March 4, 1983, "A Primer on Discount Brokers" and June 26, 1987, "Discounters' Dozen Years." These prior issues, moreover, were meant to fill the void on discount brokers which was created when the U.S. Securities and Exchange Commission (SEC) discontinued its analysis of this segment of the securities industry. The last SEC study analyzing discounters was their Staff Report on the Securities Industry in 1980.

In order to avoid repetition, and undue lengthy reporting, this issue of Trends does not again review the advent and history of discounters nor our previous critiques and analysis of the various universes of discounters and methodologies used by the SEC and the SIA in the Seventies and early Eighties. For those interested in a more complete history of discounters, much of this can be found in last year's "Discounters' Dozen Years" or the previously cited reports on discounters.

This issue concentrates on recent performance and market share of "pure" discount broker-dealers (those broker-dealers identified as mainly engaged in the agency equity commission business and holding themselves out as discounters) and their clearing businesses.

Issues of Trends which analyze the profitability of the securities industry and different firm categories utilize a universe of New York Stock Exchange (NYSE) member firms which deal with the public based on data from their quarterly FOCUS

Reports submitted to the Exchange. These categories, known as SEC/SIA firm categories, are familiar to the long-term Trends reader. Examples are National Full Line firms, Large Investment Banks, Regional firms, etc.

The Discounter group, as with other categories, deals with those discounters which are members of the NYSE. However, NYSE Discounters are relatively few in number (currently 26) although they have accounted for the majority of discounters' business in recent years (see Table 2). Also, the "total industry" in other issues of Trends also deals only with NYSE members which deal with the public (around 400 firms accounting for around 80% of all broker-dealers' revenues and 85% of their assets).

For this (and prior) analysis of discounters, we expand the universe of discounters and total industry beyond NYSE firms and include members of the National Association of Securities Dealers (NASD) in these two universes (exclusive of double counting).

In some cases, such as in Table 7, we refer to just the NYSE discounters and all NYSE firms as discounters and "total" industry, to allow us to analyze this year's first quarter (because NASD data is still not available). There is a much longer lag time in obtaining FOCUS data about the sole NASD members (one reason we use just NYSE firms in our other analysis). When using either of the two universes, however, they are clearly indicated and the reader should be aware of this distinction.

DISCOUNT BROKERS -- BOOM TO BANE

There is no group of securities firms more dependent on commission revenues and the retail investor than the discount broker. This focus and dependence was a boon to these firms during the bull market's unprecedented investing fervor but has become a bane in the post-October world.

Retail investors, the lifeblood of many securities firms including the discounter, closed up shop after last October's market break. For example, commissions, discounters' bread and butter revenue source, fell 27% in the first quarter of this year from the same period a year earlier. Moreover, the $2.4 billion in commissions that New York Stock Exchange member firms did manage to eke out in the anemic environment of 1988's first quarter was the poorest quarterly showing since 1985!

In the immediate aftermath of October's crash, 1987's fourth quarter, the securities industry suffered its largest quarterly loss ever -- over $2 billion in red ink before taxes, 22 times the previous record quarterly loss. As a group, the NYSE and NASD discounters also showed a loss in the fourth quarter of last year, $42 million. However, this was not due to a quarterly drop in commissions or revenues. In fact, boosted by October's huge transaction volume, the fourth quarter was actually the best in terms of commissions for the discounters, $224 million (Table 1), and revenues of $360 million were about even with the preceding three quarters.

Table 1

1987 QUARTERLY PERFORMANCE OF NYSE/NASD FIRMS

(In Millions of Dollars)

	Q1	Q2	Q3	Q4
Discounters				
Commissions	212.3	207.4	207.3	223.7
Revenues	363.3	364.4	362.7	359.8
Pre-Tax Profits	66.1	53.7	40.2	(42.0)
Equity Capital	595.8	677.4	711.6	664.9
All Firms				
Commissions	4,125.7	3,816.8	3,959.3	4,032.8
Revenues	17,994.1	15,708.5	16,442.3	13,206.9
Pre-Tax Profits	2,587.6	761.6	910.4	(2,343.1)
Equity Capital	30,310.7	31,140.8	32,374.5	32,717.8

Losses in error accounts and bad debts skyrocketed for the securities industry in October. DKs and unmet margin calls plagued the industry that month, although given the unprecedented 600 million share days on the Big Board and the biggest market crash ever, things actually ran rather smoothly. Discounters, as a group, saw this loss error expense line jump from an average $1-$2 million per quarter to over $60 million in the fourth quarter. That explosion turned a potential $20 million profit into a $42 million loss. A good portion of this loss is probably attributable to one well-publicized loss in a single account at one discounter.

According to another SIA Research publication, the Investor Activity Report (IAR), the average daily **"retail"** activity on the Big Board,[1] both purchases and sales, hit a record 183 million shares per day in October ("share activity," by counting both sides of a transaction, buy/sell, is generally double the reported "volume" activity reported by exchanges). One month later, November's retail activity was down to 128 million shares daily. The sluggish activity, particularly retail, so far in 1988 does not bode well for the discounters. According to the IAR, estimated NYSE retail activity fell to 86 million shares daily in the first quarter and continued to slide down to a mere 80 million shares daily by May! Also, this slowdown was even more evident on other marts including the AMEX and NASDAQ.

What has this done to the discounters' P&L so far this year? Unfortunately, as mentioned, first quarter results for all discounters are still not available. However, we can look at the group of discounters which are NYSE members. Although this group contains just over two dozen firms, it incorporates all the large national discounters and the group as a whole accounts for most of the discounting business as shown in Table 2.

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[1] Retail activity is derived by taking total purchases and sales on the New York Stock Exchange (NYSE) and then subtracting all institutional sales and purchases reported through the Depository Trust Co.'s Institutional Delivery System and all NYSE member trading reported to the NYSE on Form 121. The remaining share activity, after estimated adjustments for dividend recapture programs and corporate stock repurchase programs, is considered "retail."

Table 2

NYSE DISCOUNTERS' SHARE OF ALL DISCOUNTERS

(In Percent)

	1986	1987
Commissions	82.4	84.3
Revenues	81.5	84.8
Expenses	80.7	84.4
Pre-Tax Profits	86.0	89.4

As Table 3 clearly shows, NYSE Discounters' business in the first quarter of 1988 has fallen back to 1986 levels in both commissions and total revenues. However, their expenses have not been pared back to 1986 levels, although they have been pared back quite a bit since October. Profits are about one-third their 1986 levels while their pre-tax profit margin has been slashed to a meager 4%.

Table 3

NYSE DISCOUNTERS QUARTERLY PERFORMANCE

(In Millions of Dollars)

	86:Q1	86:Q2	86:Q3	86:Q4	87:Q1	87:Q2	87:Q3	87:Q4	88:Q1
Commissions	134	138	134	134	177	174	175	191	133
Revenues	222	227	214	231	303	308	311	308	255
Profits	44	38	31	28	57	49	39	(39)	10
Profit Margin	20%	17%	14%	12%	19%	16%	13%	(13%)	4%

Of course, the discounters are not the only firms who have suffered since October. Other categories of NYSE firms who also depend a great deal on the retail customer are the National Full Line and Regional firms. Table 4 shows how the NYSE Discounters and these two groups (as well as all NYSE firms) have fared in profitability during the Eighties. In most years, the discounters' profit margins and ROE have been the best of all these groups. However, so far this year, the discounters have lagged the NYSE group as well as the Regional firms and performed only slightly better than the National Full Line group which historically has operated on the thinnest margins of any category of firms.

Table 4

PRE-TAX PROFIT MARGINS

(In Percent)

NYSE Firm Category	80	81	82	83	84	85	86	87	88:Q1
National Full Line	10.9	6.9	8.8	8.6	(0.9)	5.6	6.9	(0.9)	1.4
Regionals	14.7	11.2	11.1	12.6	2.6	9.4	11.0	5.5	4.3
All NYSE Firms	14.1	10.8	13.1	12.9	5.2	10.7	11.0	2.3	8.7
NYSE Discounters	**17.5**	**12.2**	**13.6**	**14.0**	**0.3**	**8.9**	**15.7**	**8.6**	**3.8**

PRE-TAX RETURN ON EQUITY

(In Percent)

NYSE Firm Category	80	81	82	83	84	85	86	87	88:Q1
National Full Line	45.0	24.6	29.8	28.1	(2.6)	17.9	20.3	(2.1)	2.9
Regionals	N.A	37.2	36.0	40.5	6.8	29.0	32.7	14.1	9.2
All NYSE Firms	49.2	35.9	40.5	36.6	13.3	29.4	28.6	4.9	18.1
NYSE Discounters	**N.A**	**52.2**	**53.9**	**46.7**	**0.8**	**25.6**	**49.5**	**19.7**	**6.4**

Also, after several years of waning profitability in the early Eighties, the discounters appeared to be making a strong comeback by 1986, but last year's events put an abrupt halt to this progress.

DISCOUNTERS' MARKET SHARE

The most often asked question regarding discounters seems to be: "What is their market share?" For about a decade, there seems to have been a never-changing number bandied about in the financial press, at conferences, etc., which is the "never-sourced" answer to this question -- 20%!

This may be an attempt to define market share as the share of retail transactions, but it is not proven and in any case wouldn't have remained constant!

However, since we know of no way to track retail transactions, we will, as in the past, measure discounters' market share in terms of their share of monies generated: revenues, profits, commissions and estimated retail commissions. Tables 5 and 6 show the results of all discounters vs all firms for the past five years (both NYSE and NASD broker-dealers) and the discounters' market share. Two assumptions are made in determining discounters' market share of retail commissions. The first, based on informal surveys of SIA member firms, is that two-thirds of the industry's commissions are from retail activity. The second is that 100% of discounters' commissions are from retail activity, although the actual figure is probably somewhat lower.

The first striking fact is that discounters, despite a relatively poor 1987, continued to gain market share in commissions, retail commissions, revenues, and particularly profits. This matches what we've already seen--despite discounters' falling profitability in 1987, the total securities industry's declining profitability was so much more severe, that discounters' slice of the much smaller pie was relatively bigger.

Table 5

DISCOUNTERS

($ Millions)

	1983	1984	1985	1986	1987
Commissions	335.3	325.9	443.0	654.5	850.7
Revenues	529.9	595.1	770.0	1,096.8	1,450.2
Expenses	467.6	589.1	701.3	933.5	1,332.2
Pre-Tax Profits	62.3	6.0	68.7	163.3	118.0
Return on Equity	35.8%	2.7%	26.2%	45.6%	19.3%

(% Share of Total Industry)

	1983	1984	1985	1986	1987
Commissions	3.4	3.7	4.2	4.9	5.3
Revenues	1.5	1.6	1.6	1.8	2.3
Pre-Tax Profits	1.4	0.3	1.3	2.3	6.2
Estimated Retail Commissions*	5.1	5.6	6.4	7.3	8.0
No. of Firms	106	120	117	122	122

*Retail commissions for the total industry are estimated to be two-thirds of total commissions while all discounters' commissions are considered retail.

Table 6

TOTAL INDUSTRY

($ Millions)

	1983	1984	1985	1986	1987
Commissions	9,840.4	8,763.3	10,432.9	13,430.1	15,934.6
Revenues	34,336.4	37,048.0	46,844.3	61,017.7	63,351.8
Expenses	29,810.7	34,908.5	41,459.2	53,905.5	61,435.3
Pre-Tax Profits	4,525.7	2,139.6	5,385.1	7,112.2	1,916.5
Return on Equity	34.6%	14.0%	29.8%	28.8%	6.2%
No. of Firms	4,027	4,867	5,714	6,387	6,331

But what about the tough year we are now in? Have discounters managed to keep their market share of this year's small pie? As previously noted, all discounter data is not yet available. But if we take the NYSE Discounters' share of all discounters' financials for the past two years (as in Table 3) and project it onto what the NYSE Discounters reported in the first quarter, discounters lost some market share in 1988's first quarter, particularly in profits (Table 7).

Table 7

DISCOUNTERS' MARKET SHARE

(In Percent)

NYSE Discounters' Share of NYSE Firms

	86	87	88:Q1
Commissions	5.1	5.7	5.5
Revenues	1.8	2.4	2.0
Pre-Tax Profits	2.5	9.0	0.9
Estimated Retail Commissions*	7.7	8.5	8.2

NYSE NASD Discounters' Share of All NYSE/NASD Firms

	86	87	88:Q1*
Commissions	4.9	5.3	5.2
Revenues	1.8	2.3	2.0
Pre-Tax Profits	2.3	6.2	0.1
Estimated Retail Commissions*	7.3	8.0	7.8

*Estimated based on 1986-87 NYSE vs NYSE/NASD market shares.

These estimated drops in market share for all discounters from 5.3% to 5.2% of commissions, 2.3% to 2.0% in revenues and 8.0% to 7.8% in retail commissions do not look too drastic for 1988's poor environment (although their drop in share of profits was severe). One should remember, however, that these slightly lower market shares are percentages of a much, much smaller retail revenue base this year!

THE EARLY YEARS

As mentioned, the SEC began tracking discounters as a group in the Seventies. Although some securities firms engaged in the practice of discount commissions for certain types of allowable transactions prior to May 1, 1975, that date, "May Day," marked the end of all mandatory, fixed-rate commissions for the securities industry, and thus the dawn of discounters.

The SEC identified 70 firms it considered discounters in 1975 which grew to 82 the following year. For the years 1977 through 1980, the SEC, in its Staff Report on the Securities Industry in 1980, compared an identified universe of discounters to the total securities industry in terms of commissions and total commissions (Table 8). Since the SEC discontinued tracking this group of firms for subsequent years, SIA followed the SEC's basic analysis for the following two years. Table 8 combines the two analyses which shows that both the number of discounters and their market expanded each year. Although this analysis cannot be directly compared to our previous analysis of discounters for years after 1982 (the universe of discounters after 1982 was adjusted by eliminating firms which were not considered "pure" discounters), both analyses show that discounters continued to expand in both number and market share year after year, through 1987.

Table 8

DISCOUNTERS' EARLY GROWTH*

(Dollar Amounts in Millions)

	1977	1978	1979	1980	1981	1982
Industry Commissions	$3,035	$4,036	$4,512	$6,377	$6,143	$6,454
Discounters' Commissions	$70	$103	$137	$241	$251	$314
Discounters' Share	2.3%	2.5%	3.0%	3.8%	4.1%	4.9%
Estimated Industry Retail Commissions	$1,982	$2,736	$3,023	$4,234	$3,987	$3,743
Discounters' Market Share of Retail Commissions	3.5%	3.8%	4.5%	5.7%	6.3%	8.4%
Number of Discounters	90	99	114	125	131	136

*The universe of discounters analyzed here differs from those analyzed in subsequent years and thus is not directly comparable to analysis of discounters for years 1983 and beyond.

Source: U.S. Securities and Exchange Commissions' "Staff Report on the Securities Industry in 1980" (for years 1977-1980); Securities Industry Association (1981 and 1982).

Based on our previous discussion of the NYSE Discounters' performance in this year's first quarter, it would appear that the post-October market environment has halted, at least temporarily, this expansion. However, 1988 is far from over and the true answer will be visited again in a future Trends issue. Frankly, not only discounters, but the entire securities industry anxiously awaits the return of the individual investor.

George R. Monahan
Director of Industry Studies

VOLUME

	APR 1988	YTD 1988	APR 1987	YTD 1987	% CHAN Q1 1988-1987
AVERAGE DAILY SHARE VOLUME ON					
NYSE (MILS.)*	163.0	174.7	187.1	186.0	-6.1%
AMEX (MILS.)*	10.5	10.7	14.4	15.0	-28.5%
NASDAQ (MILS.)*	125.1	127.7	144.3	151.9	-15.9%
REGIONAL EXCHANGE (MILS.)*	23.7	24.7	28.2	28.3	-13.0%
DOLLAR VALUE OF SHARES TRADED ON					
NYSE (MILS.)	$111,280	$482,813	$172,672	$645,221	-25.2%
AMEX (MILS.)	2,671	11,103	4,369	19,519	-43.1%
ODD LOT SHARES PURCHASED ON NYSE (THOUS.)	7,774	30,326	13,140	47,144	-35.7%
ODD LOT SHARES SOLD (INCLUDING SHORT SALES) ON NYSE (THOUS.)	14,826	59,609	19,575	77,050	-22.6%
NYSE BLOCK VOLUME AS A PERCENT OF TOTAL SHARES TRADED	50.7%	51.6%	49.2%	50.7%	----
CONTRACTS TRADED (THOUS.)					
CBOE OPTIONS	9,282	36,412	18,715	70,175	-48.1%
AMEX OPTIONS	3,051	12,556	4,766	18,065	-30.5%
COMMODITY	17,786	76,364	23,203	71,866	6.3%

*MONTHLY AVERAGE
N/A - DATA NOT AVAILABLE

PRICES
(END OF MONTH)

	APR 1988	APR 1987	% CHAN APR 1988-1987
DOW JONES INDUSTRIALS	1988.06	2032.33	-2.18%
STANDARD & POOR'S 500	258.89	261.33	-0.93%
NYSE COMPOSITE	146.60	147.87	-0.86%
AMEX MARKET VALUE INDEX	296.43	303.14	-2.21%
VALUE LINE COMPOSITE	228.14	229.79	-0.72%
NASDAQ COMPOSITE	374.64	379.24	-1.21%

YIELDS

(MONTHLY AVERAGES)

	APR 1988	APR 1987	BASIS POINT CHG 1988-1987
BOND BUYER INDEX (20 BOND)	7.81%	7.55%	26
CORPORATE BOND YIELDS (MOODY'S)			
Aaa CORPORATE	9.67	8.85	82
Baa CORPORATE	10.90	10.04	86
RATIO Aaa CORPS. TO Baa CORPS.	0.89	0.88	1

	FIRST HALF 1988	FIRST HALF 1988	% CHANGE FIRST HALF 1987-1988
CORPORATE FINANCING (Gross New Issues - $ Mils)			
TOTAL	$143,760.7	$158,220.7	-9.1%
Common Stock	$16,033.7	$25,591.6	-37.2%
# of Issues	196	512	-61.7%
Preferred Stock	$3,414.3	$6,983.2	-51.1%
# of Issues	61	96	-36.5%
Corporate Bonds	$124,312.8	$125,646.0	-1.1%
# of Issues	1,543	1,321	+16.8%

MUNICIPAL FINANCING (Gross New Issues - $ Mils)			
Negotiated	$38,195.9	$44,652.2	-14.5%
# of Issues	1,525	1,776	-14.1%
Competitive	$13,976.2	$13,281.3	+5.2%
# of Issues	1,604	1,821	-11.9%

RECENT INTERESTING READING AND STATISTICAL MATERIAL

Item	Description	Source
Wall Street's Workforce	The first ever comprehensive analysis of Wall Street's workforce based on a one-year study by SIA and Arthur Andersen. The 63-page book contains about 70 exhibits, and details headcount and productivity levels in the securities firms and the workforce itself. Example of the study's many findings: National Full Line firms generate 12.1 retail tickets daily for each retail producer, while clearing 13.6 retail tickets daily for each retail support person.	SIA Publications Dept. $150, SIA members; $250, others
Securities Industry Yearbook 1988-89	Ninth edition, 802-pages, containing detailed information on the over 550 securities firms that are members of SIA. Five part book includes rankings of firms by capital and number of offices, employees and salespersons; description of firms by type of business; geographic listing of firms; industry and market statistics; and SOURCES, the securities executive's guide to products and services.	SIA Yearbook Dept. $55, SIA members $90, others
"The Profitability of Insured Commercial Banks in 1987"	Annual article on commercial banks prepared by Federal Reserve Board of Governors. Huge provisions made by large banks for possible loan losses were the key to an unprecendented drop in the profitability of U.S. chartered insured commercial banks in 1987. The provisions, which were largely to cover troubled loans to developing countries, sharply reduced the industry's ROA and ratio of equity capital to assets. These provisions coupled with certain regional problems pushed more than 2,000 banks -- one-sixth of the total -- into the red in 1987. Article contains statistical measurements of profitability from 1983 to 1987.	Federal Reserve Bulletin July 1988
"First Half Financing Rankings"	Total first half 1988 underwritings came in at $143.8 billion, a 9% drop from the comparable period in 1987. Finishing on top overall as lead manager was Merrill Lynch, which captured 15.1% of all domestic corporate financing business. This is the first time Merrill has captured the number one spot in several years. Statistical data ranked by type of underwriting, including mortgage-backed and asset-backed securities.	Investment Dealers' Digest 7/11/88

Item	Description	Source
"Where have all the gurus gone?"	Stardom is out and marketing is in as Wall Street economists get down to the business of selling their firms. Brief review of Henry Kaufman's career at Salomon Brothers, followed by interviews with economists at several top firms discussing the parameters and demands of today's clients.	Institutional Investor July 1988
"Donkeys, Elephants, Bulls, Bears"	Are the Democrats or the Republicans better for the market? Short article with detailed graphics traces the Dow and economic statistics to present through Administrations starting with Truman. Conclusion: The Dukakis-Bush contest may decide who will be living at 1600 Pennsylvania Avenue, but its unlikely to provide much of a guide as to what's ahead for Wall Street or Main Street.	Barron's 7/25/88
The Impact of the Tax Reform Act of 1986 on the International Competitiveness of Service Industries	Three-part detailed examination, containing international tax survey and sectoral studies. Concludes: 1. Overall the 1986 Act has imposed a new obstacle to the competitiveness of the U.S. service sector exports and sales by foreign affiliates, and 2. The adverse effects are highly concentrated by sector, with banking, shipping, and insurance suffering large adverse effects.	Coalition of Service Industries, Inc. 2001 M. Street, N.W. Washington, D.C. 20036
"Treasury Defends Report on Capital Gains Taxes"	Authors of Treasury study, "The Direct Revenue Effects of Capital Gains Taxation," which found credence in the claim that lower capital gains taxes can produce additional revenue respond to Joseph Minarik's criticism of their methodology.	Tax Notes 7/25/88

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Securities Industry
Trends
AN ANALYSIS OF EMERGING TRENDS IN THE SECURITIES INDUSTRY
Produced by the SIA Research Department

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COPING WITH COSTS IN A REVENUE DROUGHT

On the eve of the anniversary of last year's stock market crash, one fact has become perfectly clear: until revenue sources rebound, securities firms must continue to limit their costs or face ever narrowing bottom lines.

Highlights

1. The securities industry managed to bring average quarterly expenses down 4% in 1988's first half vs. 1987's quarterly average. Since revenues held even, average profits doubled over last year's admittedly anemic level.
2. While costs and profits improved for the half vs. 1987's rock bottom levels, 88's profit margin and ROE virtually tied 1984's performance, the second lowest of the Eighties.
3. Despite strenuous efforts at cost control, the industry's profitability in the second quarter fell 50% from the first quarter whether measured by total profits, profit margins, or ROE.
4. Retail-oriented firms are still the hardest hit. Average revenue per employee at the Regional firms is down $19,000 per person for 1988 vs. 1987 and down a shocking $64,000 per person at the Discounters.
5. Reflecting a capital base which has been expanding much faster than the revenue it generates, the securities industry now books only $2 in revenues for every $1 in equity capital. In other words, the industry, today, because of a much greater capital base, would have to more than double its 1980 profit margin (its highest since 1972) in order to just match its 1980 ROE!

INTRODUCTION

We are fast approaching one year since the October 19th meltdown and conditions continue to deteriorate in the securities industry. In our previous profitability analysis, we noted that the aftershocks of October 19 were still being felt by the securities industry and capital markets. One of our key findings was that the aftershocks have been mainly felt in the retail area. The most recent data, which includes the second quarter of 1988, shows that firms concentrating in the retail sector are facing further profitability deterioration while even the investment banking and trading hemisphere saw profit margins and returns on equity deteriorate in the second quarter.

Financially, conditions deteriorated for the industry during the second quarter as revenues dropped about $600 million while costs remained flat at $11.9 billion. Revenues declined from $13.0 billion to $12.4 billion during the 2Q88. Commission revenues were down by roughly $200 million, trading profits by over $400 million while firm investment accounts dropped another $600 million. These declines were offset partly by increases in underwriting revenues of $200 million and revenues related to the securities business, up $300 million, mainly reflecting increased M&A activity.

Any modest gains that were achieved in cost savings between the 1Q88 and 2Q88 were wiped out by a $200 million increase in interest expense due to rising interest rates. Thus, with costs literally flat between quarters and revenues falling about $600 million, the entire revenue decline was felt in profits which plummeted from $1.1 billion to about $550 million. The industry's pre-tax profit margin and ROE were literally cut in half between the first and second quarters of 1988. Pre-tax profit margin and ROE fell from 8.7% to 4.8% and from 18.1% to 9.3%, respectively.

Pre-tax profit margin and ROE were 6.7% and 13.4%, respectively, for the 1H88. Although these figures are disappointing, particularly given the risk and volatility of earnings in the securities industry, the 1H88 figures are higher than those for the worst years in the 80's, 1984 and 1987. In those two years, pre-tax profit margins were 5.2% and 2.3% respectively; while pre-tax ROE was 13.3% and 4.9% respectively. These comparisons are shown in Table 1.

Table 1

POOREST PROFIT PERIODS OF THE EIGHTIES

	1984	1987	1H88
Pre-tax Profit Margin	5.2%	2.3%	6.7%
Pre-tax ROE	13.3%	4.9%	13.4%

Despite strenuous efforts at cost control, the industry's profitability in 2Q88 still fell more than 50% whether measured by total profits, profit margins, or return on equity. For the first six months of this year, ten of the fourteen cost lines on the FOCUS Report showed declines relative to 1987 on an average quarterly basis. Nevertheless, average quarterly costs were only reduced by slightly over 4% in the 1H88 relative to 1987.[1]

Surprisingly, "clerical and administrative" costs, on an average quarterly basis, were up almost 6% in 1988. This cost increase occurred despite a decline of about 6% in non-producing employees since the crash and a 1.3% drop in the average number of non-producers during the 1H88 relative to the average number of such employees in 1987. Based on the FOCUS Reports, "non-producers" declined by 6,784 as of June 30, 1988 relative to the average figure in 1987, 162,806, and declined a greater 12,215 from their peak level 12 months earlier. This category is a very broad classification of employees including everybody but producing RRs. But, it suggests that unless conditions improve soon in the industry, further layoffs may take place, raises may be curtailed, or the possibility of cutbacks in wages and salaries being imposed upon the current labor force. Though much has been already imposed along these lines (see next section on employment and compensation), some firms, particularly the retail-oriented, have room for further tightening.

The other major cost item limiting the overall cost decrease is interest expense which was down only 2.5% during the 1H88 relative to the quarterly average in 1987. For the most part, this was due to interest rates trending upwards since 1987. The six-month commercial paper rate rose from 6.8% in 1987 to 7.5% in June 1988 while most other short and long term rates were also up from 50 to 100 basis points over 1987's average. Since clerical and administrative salaries plus interest expense comprise almost 50% of the industry's total costs, it is clear why overall costs are down only 4% with interest rates rising and clerical and administrative salaries actually higher than in 1987.

In order for further improvements to be made on the cost front, interest costs have to be curbed further. This will be difficult to achieve given the surge in rates in August. During the 1H88, the yield curve has been narrowing. From January-June, rates on federal funds and 3-month T-Bills went up about 70 basis points. Meanwhile, rates on 10, 20 and 30-year Treasuries went up 26, 16, and 17 basis points, respectively.

A further tightening of clerical and administrative salaries seems to be the only cost item with room for further improvement in 3Q88. This improvement may come not from eliminating additional job positions, but limiting increases in salaries that have gone to certain employees remaining on the payroll, or outright further reductions (see next section). For clerical employment, this cost item has been exceeding the average for 1987, despite a reduction in the number of such employees. This trend cannot continue unless the environment surrounding the industry suddenly improves or, more specialized employees with greater training and experience are being retained while less "essential" employees are being let go. Frankly, there is no evidence about this possibility, one way or another.

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[1] According to the latest FOCUS Report, about 3,400 jobs were eliminated by NYSE firms dealing with the public during the second quarter of 1988. This was about 1.4% of the labor force as of March 30, 1988. Interestingly, according to figures released by the Toronto Stock Exchange, almost 600 jobs were eliminated by members during this same time period. These jobs represented about 2.4% of the Canadian securities industry's labor force, leaving them with 24,274 employees as of June 30. See Financial Times, September 22, 1988, p. 22.

Since employment and compensation are so large a cost factor for the securities industry, let's review what has already occurred on this front since last year.

EMPLOYMENT AND COMPENSATION

As discussed earlier, securities firms have moved rapidly to contain and curtail expenses since October's events plunged the markets into rough waters. Since the securities industry expends over 40¢ of every $1 of revenue on direct compensation alone, headcount was the first and prime target of cost control measures. Table 2 shows the immediate result of these measures. Over the nine month period beginning September 30, 1987, just 19 days before the "crash," until this past June 30, over 17,000 jobs, or 6.6% of the workforce, was eliminated or left the securities industry. The bulk of this loss was at the National Full Line firms, both because they employ the vast majority of securities industry personnel (see Appendix A) and because of the elimination of positions from the combination of the two mega firms, Shearson Lehman and E.F. Hutton.

Table 2

NET EMPLOYMENT CUTS SINCE THE CRASH*

Category:	Producers		Non-Producers		Total	
National Full Line	(7,012)	(11.4%)	(4,481)	(5.1%)	(11,493)	(7.7%)
Large Investment Banks	(449)	(4.6%)	(2,668)	(9.7%)	(3,117)	(8.4%)
Regional Firms	(105)	(0.6%)	(1,367)	(5.6%)	(1,472)	(3.5%)
NYC-Based Regionals	(184)	(3.3%)	(111)	(1.1%)	(295)	(1.9%)
NYSE Discounters	68	6.5%	(245)	(6.6%)	(177)	(3.7%)
All Other	43	3.1%	(689)	(6.0%)	(646)	(5.0%)
Total Industry	**(7,639)**	**(7.9%)**	**(9,561)**	**(5.8%)**	**(17,200)**	**(6.6%)**

*Employment change 9/30/87 to 6/30/88.

Nevertheless, over 8% of the Large Investment Bank workforce has been trimmed and except for a 2% net reduction in the New York City-based regional workforce, other categories of firms witnessed 4%-5% net reductions.

But these are just comparisons of staffing levels at two points in time. A better comparison, from a cost comparison perspective, is to look at last year's average employment levels vs. this year, and comparative compensation levels.

The mean employment of the industry so far in 1988 is 251,271 employees (average of beginning employment and levels at the end of each of the two quarters through June) as seen in Table 4. This is down only 1.7% from the mean employment last year (average of the 1987 beginning employment level and levels at the end of each of the four quarters), although the June 30 level is a lower 244,963. Also, though all categories of firms have had net employment reductions from their pre-crash highs, this year's average employment is down only slightly from last year and for some groups, such as the NYCs and Discounters, average employment is actually up! The net reductions, so far, have served to eliminate the added employment prior to the October 19 crash.

Table 3

TOTAL COMPENSATION EXPENSE

(In $ Millions)

	1987	1988*	$ Change	% Change
National Full Line	10,568.0	10,004.4	(563.6)	(5.3)
Large Investment Banks	4,209.0	4,271.6	62.6	1.5
Regionals	2,773.5	2,312.8	(460.7)	(16.6)
New York City-Based	1,632.5	1,457.6	(174.9)	(10.7)
Discounters	307.9	294.4	(13.5)	(4.4)
Total Industry	**20,553.5**	**19,410.2**	**(1,143.3)**	**(5.6)**

*First Half Annualized

Table 4

AVERAGE EMPLOYMENT

	1987	1988*	Change	% Change
National Full Line	146,989	141,953	(5,036)	(3.4)
Large Investment Banks	36,201	35,479	(722)	(2.0)
Regionals	41,124	41,022	(102)	(0.2)
New York City-Based	14,812	15,891	1,079	7.3
Discounters	4,488	4,764	276	6.1
Total Industry	**255,655**	**251,271**	**(4,384)**	**(1.7)**

*First Half

However, although average employment has fallen less than 2% since last year, total compensation costs have been cut almost 6% (Table 3). The industry spent $20.6 billion on direct compensation in 1987, but annualized first half compensation is $19.4 billion, more than a $1 billion savings and more so if the trend continues down for the remainder of the year, which appears extremely likely as of this writing.

For some categories of firms, the compensation cuts are more impressive. Regional firms' 1988 average employment is only 0.2% (or about one person per firm) below last year's average. Meanwhile, their annualized 1988 compensation expense is running almost 17% below last year's! Also, NYCs and Discounters, though mean employment has risen slightly, have managed to cut this year's compensation costs.

Again, these are statistical averages and are not intended to portray, for instance, that the typical Regional firm has not seen employment reductions, but compares net average employment and compensation expense of the entire group for 1987's full year to 1988's first half. If one looked at just six month reductions through June, Regionals' employment fell over 2,000, or over 21 employees per firm, but this does not relate to average employment and compensation.

Have these cost control measures increased productivity of the remaining workforce and reduced expenses? Comparing the average compensation per employee last year to the revenues generated per employee last year relative to 1988 (first half annualized) shows some striking examples. For the securities industry as a whole, 1988's compensation expense was slashed 5.6%, but per employee it was not as drastic -- a 4% drop, since average employment was cut 1.7%. Meanwhile, the remaining, albeit smaller, workforce managed to generate 2.2% more revenues per person than last year. That's good, but hardly a quantum leap in productivity. Further, that increase in revenue per employee is concentrated in the investment banking-oriented firms, LIBs and NYCs, which have seen their revenues and profits boosted by the only businesses still strong this year, such as M&A fees. Reflecting the plunge in equity and mutual fund business,[2] Regionals' revenues per employee are down 16% while Discounters' are down 24%!

These "productivity" trends show once again that securities firms often cannot control their own destiny and are extremely dependent on external factors affecting the psychological and economic environment in which they operate.

Table 5

AVERAGE REVENUE PER EMPLOYEE

(In $ Thousands)

	1987	1988*	$ Change	% Change
National Full Line	147.5	145.5	(2.0)	(1.4)
Large Investment Banks	408.1	445.8	37.7	9.2
Regionals	120.6	101.7	(18.9)	(15.7)
New York City-Based	306.3	314.7	8.4	2.7
Discounters	274.2	209.9	(64.3)	(23.5)
Total Industry	**198.7**	**203.1**	**4.4**	**2.2**

*First Half Annualized

Meanwhile, the compensation drops are merely matching, or worse, falling short of the revenue declines. Regionals' average compensation per employee fell $11,000, far short of their $19,000 drop in revenues per employee, while Discounters' severe $64,000 drop in revenues per employee far exceeds their $7,000 drop in compensation cost per employee this year!

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[2] The net sales of equity, bond and income mutual funds continue to remain vastly depressed relative to immediate prior years. Through the first half of 1988, only $3.6 billion of net sales were made. This compares with over $74 billion of net sales in 1987 and over $148 billion in 1986, and about $81 billion in 1985. We have to go all the way back to 1982 before the net sales for the first half even approach an annual level for an earlier year.

Table 6

AVERAGE COMPENSATION PER EMPLOYEE

(In $ Thousands)

	1987	1988*	$ Change	% Change
National Full Line	71.9	70.5	(1.4)	(1.9)
Large Investment Banks	116.3	120.4	4.2	3.5
Regionals	67.4	56.4	(11.0)	(16.3)
New York City-Based	110.2	91.7	(18.5)	(16.8)
Discounters	68.6	61.8	(6.8)	(9.9)
Total Industry	**80.4**	**77.2**	**(3.2)**	**(4.0)**

*First Half Annualized

Table 7

AVERAGE NET REVENUE PER EMPLOYEE

(In $ Thousands)

	1987	1988*	$ Change	% Change
National Full Line	75.6	75.3	(0.3)	(0.4)
Large Investment Banks	291.8	325.4	33.6	11.5
Regionals	53.2	45.3	(7.9)	(14.8)
New York City-Based	196.1	223.0	26.9	13.7
Discounters	205.6	148.1	(57.5)	(28.0)
Total Industry	**118.3**	**125.9**	**7.6**	**6.4**

*First Half Annualized

Therefore, the retail-oriented firms' after-compensation net revenues per employee fell from 1987 to 1988. Despite employment cutbacks and a reduction in compensation for the remaining workforce, the slowdown in retail business has been so severe that the net revenue per employee couldn't be maintained. For the NFLs, the net revenue drop was only $300 per employee, or 0.4%, but the NFLs have just as large an investment banking source of revenues as the LIBs, the one area still humming along so far in 1988.

Regionals, which also have investment banking revenues, albeit much smaller, saw their net revenue per employee fall 15%. Discounters, almost entirely retail commission dependent, saw their net revenue plummet $57,500 per employee or 28%!

The investment banking concentrated firms, LIBs and NYCs, saw these figures rise $34,000 and $27,000 per head, respectively, or 12% and 14%. These two groups helped bring up the net revenue per employee figure for the total industry, with a $7,600 or 6.4% rise for 1988 over 1987.

So, where most of the aggregate employment reductions have occurred, at the NFLs, on a firm-wide basis these reductions, coupled with lower compensation, have kept the net revenue per head constant during these tough times. And though there's a vast difference between the purely retail and purely investment banking firms, as an industry, the remaining workforce is managing to generate roughly the same amount of revenues and net revenues per person in 1987 and 1988.

Furthermore, this year's showing is still impressive compared to the bull years of the Eighties. Table 8 shows that the total revenues generated per employee has been growing across the board, and 1988's results, given the poor market environment, are historically quite good. Of course, each employee has more of other resources to work with in terms of both capital and technology which are essential to their productivity.

Table 8

REVENUE PER EMPLOYEE

(In $ Thousands)

Firm Category	80	81	82	83	84	85	86	87	88*
National Full Line	90.5	89.6	98.6	114.8	106.6	131.1	157.6	147.5	145.5
Large Investment Bks	232.9	316.5	348.6	342.8	402.1	448.8	490.9	408.1	445.8
Regionals	N.A	87.1	89.1	105.9	89.5	112.6	130.7	120.6	101.7
New York City Based	N.A	136.4	131.9	156.7	145.5	167.7	290.9	306.3	314.7
NYSE Discounters	N.A	189.1	176.2	213.8	171.3	180.7	261.0	274.2	209.9
Total Industry	**114.6**	**123.2**	**135.8**	**154.0**	**150.5**	**180.0**	**213.7**	**198.7**	**203.1**

*First Half Annualized

However, though revenue per employee appears to have improved over the years and is holding its own in these rough times, returns earned on non-labor resources -- read capital -- have been deteriorating, as the next section shows, long before this year's bear.

PROFITABILITY AND THE CAPITAL MYTH

The most frequent or popular cycles used in measuring the securities industry's profitability are the "comparable year-ago period" or a bull vs. bear market period. For the latter, October 19, 1987, is now the scale's fulcrum when weighing industry profits and losses.

That's a natural reaction. Last year began with a record securities industry aggregate quarterly profit of over $2 billion but finished with a record quarterly loss of the same magnitude. Furthermore, during the bull, industry performance figures constantly showed record results compared to earlier results, and the concurrent rise in brokerages' stock prices and P/Es, lulled many into the "no limits to growth" mentality. And in a sense, this was true -- at least on the surface.

Securities industry revenues had constantly grown; in fact, they grew 25-fold from $2 billion in 1965 to over $50 billion by 1986. Aggregate industry profits also showed a near straight line climb for the past decade, rising over 13-fold from $400 million in 1977 to $5.5 billion by 1986. Industry equity capital grew from $3 billion to $24 billion over the same time frame while total capital shot from $4 billion to $30 billion. Meanwhile, employment at NYSE member firms surged from about 140,000 in 1980 to 244,000 during 1986, or almost 75%. So, all looked well with this growing industry during the bull.

But there were limits to growth. This "all is fine" appearance on the surface didn't even need a stiff breeze to expose the deteriorating profitability and increased risks beneath.

With all the growth in revenues, profits, equity and total capital, Table 9 shows the declining returns being made on this escalating capital base.

Table 9

SECURITIES INDUSTRY PRE-TAX RETURNS

(In Percent)

Pre-Tax Return on:	80	81	82	83	84	85	86	87	88*
Equity Capital	49.2	35.9	40.5	36.6	13.3	29.4	28.6	4.9	13.4
Total Capital	39.0	29.0	32.3	30.7	10.4	21.4	21.3	3.5	9.4

*First half

The previously mentioned growth masked the marginal returns earned on each new dollar of capital added. From 1980 through 1987, there was a three-fold growth in industry revenues financed by a five-fold growth in equity and total capital. Meanwhile, profits in 1987 were only half the amount booked in 1980, not even inflation or risk adjusted!

The cracks in this mask are not just now being exposed. Since the industry's recovery from 1984's lows, we've had the pleasure of reporting rebounds in profitability for the industry for the 1985 to early 1987 period but always tempered with a note of caution. The aggregates showed hopes for a rebounding industry but the returns being earned never equaled their shinier days.

In Trends, April, 1986, we discussed 1985's welcome rebound from the previous year's poor results. However, we cautioned that expenses, and thus margins, while improved, were not yet under control. For example, in the section, "Expenses - Unstoppable Force Meets Immovable Object," we noted the bad news was that over a period longer than just 1984 to 1985, expense increases still outpaced revenue gains. Further, although profits improved, we noted that 1985's profit margin was still the second lowest since the late 1970s and that ROE, although up from 1984, was still far below the 1980-83 showings!

One year later, in the March 1987 Trends, "A Tale of Two Industries," again reporting on what on the surface looked like another great year, we again cautioned that "If the year's ROE was poor, it was even more so when you consider how much the first quarter helped (keep it) from dropping off the board. For the second half of 1986, the industry was earning only 11% to 12% after taxes on its growing equity base." Further, we warned that by 1986 the industry had "increased its equity and capital base four-fold since 1980, but it only managed to increase its revenues three-fold and its profits two-and-one-half-fold."

If we look at the year-to-year growth in capital vs. revenues (forgetting for the moment the volatile swings in profits), the industry, as a whole, is hard pressed to justify using more and more capital to chase revenues, let alone "profitable" business lines (Table 10).

Table 10

YEAR-TO-YEAR INDUSTRY GROWTH

(In Percent)

	80	81	82	83	84	85	86	87	88*
Equity Capital	35	25	34	32	9	30	29	13	18
Total Capital	37	20	33	32	18	31	36	18	5
Revenues	43	23	17	27	6	24	30	1	(7)

*First half

This is not to say that securities firms didn't encounter strong pressures to vastly increase their capital during the Eighties, and even earlier. Competitive pressures literally forced firms to seek capital to survive. For Wall Street's old-line major partnerships, not much additional capital could be raised via their partnership structure. Thus, firms merged, sought outside capital-rich partners such as the insurance industry, or went public. The fastest growing profit areas were in capital risk-based areas. Non-capital intensive business lines diminished in importance, i.e., the agency commission business, which had accounted for at least half of all revenues in the mid-Seventies but decreased to about a quarter of revenues by the mid-Eighties.

Trading and investment revenues, which demanded large amounts of capital to finance inventory (and to protect against losses in this volatile area) matched commissions in revenue importance. The SEC's Rule 415 in the early Eighties even changed the nature of underwriting. In order to stay competitive in the underwriting business, firms needed large amounts of capital in order to be able to buy entire issues off the "shelf" simultaneously when issuers saw windows of opportunity to raise additional funds or to refinance.

As firms continued to raise additional capital, as we've seen in Table 10, they also increasingly leveraged this growing base. The securities industry's gross long position in securities (and commodities) grew to $145 billion at the end of 1986. That was a 10-fold increase in 10 years! Over the same time span, the industry's net long position grew eight-fold to $78 billion. The securities industry was taking larger and larger risk positions with its growing equity base. By 1984, the industry had gross long positions eight times greater than its equity base and a net long position quadruple its equity base. Though the industry began to reduce its exposure by mid-1987, October's events accelerated this trend and the amount of inventory firms are now willing to carry has contracted considerably. As of mid-year 1988, the industry's gross and net long positions were down to $109 billion and $38 billion, respectively.

Table 11

EQUITY AT RISK

Industry Long and Net Long Position vs. Equity

	80	81	82	83	84	85	86	87	88*
Gross Long Position	5.4x	5.6x	7.3x	6.0x	7.9x	8.4x	6.8x	4.1x	4.2x
Net Long Position	1.6	3.0	4.0	2.7	4.4	4.1	3.7	1.6	1.4

*As of June 30

But this leveraging was undertaken in the name of profitability. The higher the leverage and the riskier the business line, the greater the profits which can be earned...at least for placing the right bets on a hot market. As the securities industry emerged from the rough times of the early Seventies, its capital base remained at just under $4 billion, with equity capital of just over $3 billion, until this "capital quest" began around 1978. And for awhile, the infusions, combined with the beginnings of a new bull market, yielded higher returns.

As we've noted in the past and here again, less and less revenues are being generated per equity dollar. In fact, Table 12 shows that the industry is now generating only $2 for each $1 of equity, almost half of the $3.50 generated in 1980, and this drops to about $1.50 per $1 of total capital employed (total capital = equity + subordinated liabilities). In other words, the industry, today, would have to more than double its 1980 profit margin (its highest since 1972) in order to just match 1980 ROE!

Table 12

REVENUES VS AVERAGE EQUITY

	80	81	82	83	84	85	86	87	88*
Revenue X Equity	3.5x	3.3x	3.1x	2.8x	2.6x	2.7x	2.6x	2.1x	2.0x

*First half annualized

It is also argued that today's "quest for capital" is tied to a need for funds to do bridge financing and merchant banking in order to earn above average returns or just to facilitate capturing investment banking deals to begin with. And there have been spectacular returns in this arena -- but so far for only a limited number of deals for a limited number of players. There have also been some stunning hits on a few deals gone sour.

If firms need a pool of capital to tap in order to facilitate deals, a firm's own capital is certainly not the only source to tap. According to Sanford C. Bernstein's research, so far this year there are 15 major LBO funds with a target amount of $22.2 billion of capital, $17.5 billion of which has already been committed. That $22.2 billion is equal to the total capital of the 10 largest securities firms in June and more than the total capital of the securities industry at the end of 1985! Although some of this is at the disposal of the "boutiques," -- KKR, Blackstone, Wasserstein & Parella, etc., the

National Full Line firms and Large Investment Banks are the major sponsors of these funds as well.

Furthermore, the deterioration in capital returns has not been limited to those firms which concentrate more on the capital risk areas of the securities business but has been dropping across the board for all types of retail and institutional brokerages (Table 13).

Table 13

PRE-TAX RETURN ON EQUITY

(In Percent)

Firm Category	80	81	82	83	84	85	86	87	88*
National Full Line	45.0	24.6	29.8	28.1	(2.6)	17.9	20.3	(2.1)	0.7
Lg. Investment Banks	55.7	56.7	54.8	43.8	31.1	38.5	34.2	9.3	21.6
Regionals	N.A	37.2	36.0	40.5	6.8	29.0	32.7	14.1	7.2
New York City Based	N.A	42.1	43.3	50.7	19.9	31.2	35.4	3.9	22.7
NYSE Discounters	N.A	52.2	53.9	46.7	0.8	25.6	49.5	19.7	5.7
Total Industry	**49.2**	**35.9**	**40.5**	**36.6**	**13.3**	**29.4**	**28.6**	**4.9**	**13.4**

*First Half Annualized

Although some of the capital risk endeavors of securities firms are being booked outside the broker-dealer entity (as are non-domestic operations, some asset management, insurance and other non-broker-dealer operations, and thus are not totally reflected in the FOCUS reports which are the source for this Trends' analysis), the decreasing returns being reported by all types of securities firms, even during the bull market years, warrant caution.

The U.S. securities industry's increasingly deregulated and highly competitive environment suggests that the higher returns earned in the 1960s and in the early 1980s may be impossible to duplicate. The "Go-Go Years" of the 1960s, and perhaps the early 1980s, are possibly just that -- highly profitable anomalies that do go.

The industry is now dominated by huge full service financial service firms which were, and are, attracted to businesses that showed high levels of returns. Unless an industry is protected from competition, high profitability will attract new entrants and competition will force down those returns.

Witness the opening of London where competition drove down the margins and caused massive shakeouts. Tokyo's huge returns also are attracting great interest. Japan's regulatory environment protected its securities industry from competition. In 1986, Japan's Big Four -- Nomura, Daiwa, Nikko and Yamaichi -- earned a collective 65% pre-tax ROE vs. the U.S. securities industry's 28.6% or even the U.S. Large Investment Banks' 34.2%. But competition is now increasing there also as Japan's Ministry of Finance begins to open Tokyo's door.

Commercial banks have long sought re-entrance into the investment banking arena to bolster their profitability. However, the securities industry's profitability relative to banking no longer looks that enticing (Table 14).

Table 14

BANKS VS. BROKERS - AFTER-TAX ROE

(In Percent)

	83	84	85	86	87	88*
Commercial Banks	10.7	10.7	11.3	9.9	2.0	11.4
Securities Firms	19.8	7.2	15.9	15.5	2.9	8.6

*First Half

Finally, securities firms which can carefully calculate the profitability potential in arbitrage, where returns must at least exceed returns on Treasuries before committing funds for a single day, must be more careful in committing their capital to operations which produce sub-Treasury returns for entire fiscal quarters or even years.

CONCLUSION

In the past, as documented in this paper, we have been cautious about the profit, revenue, and capital increases in the securities industry during the boom period prior to October 19, 1987. We noted that although things appeared promising on the surface, there were areas of concern, namely, deteriorating profit margins and rates of return mainly because of costs increasing faster than revenues, and massive capital increases in the industry. As expected, it becomes increasingly difficult to find new lines of business where the rates of return are equal to or better than those in which firms were currently operating. This is particularly true if one adjusts for risk as firms increasingly act as principals, either in securities or even in companies.

Now, when it is easy to be pessimistic, we are increasingly turning optimistic. We believe firms have made meaningful cuts in costs and are not simply adding capital for the sake of increased size. In other words, we believe securities firms are getting lean and mean. After all, this is not exactly a normal time for the securities industry. After adjusting for dividend capture transactions, we estimate that average volume on the NYSE is off almost 19% through August, 1988 relative to the average for 1987. The average share of a price traded is down 16.5% compared to last year. Thus, "real" trading is down well over 30% through August of this year.

The American economy, particularly the corporate sector, has gone through major reorganizations and consolidation since the early Eighties. For the most part, the securities industry escaped this upheaval. However, this turbulence was brought home dramatically to the securities industry on October 19, 1987. Events around that time had a sudden, wrenching impact on the securities industry which is still reeling from the repercussions.

We do not expect to see a sudden and dramatic improvement over the first half of 1988. Indeed, we expect things to get worse rather than better in the short run, given the lackluster volume during the third quarter of this year and rising interest rates. Moreover, other areas of the business have not recovered to make up for dwindling volume and lackluster security prices. Frankly, we expect the third quarter figures, when available, to show even further declines in employment and profits in the securities industry.

We continue to believe it is important to look further than the next quarter or two as far as the securities industry is concerned. This has always been a volatile and cyclical industry. So long as the Federal Reserve continues to use monetary policy and changes in interest rates to slow or stimulate the economy, the securities industry and capital markets will remain the fulcrum from which these policies affect the real economy. For the most part, the "real" economy has weathered the storm that the securities industry has been in since October 19, 1987. Sooner or later, individual and institutional investors will regain their appetite for equities and long-term bonds or their substitutes and acquire them directly or indirectly thro[illegible] vehicles such as mutual funds. The economy is generating too much in the way [illegible]eal economic gains for this not to be reflected ultimately in security prices and greater activity. When this happens, securities firms will reap the benefits of greater revenues flowing through to the bottom line as expenses have been curbed substantially.

We need not anticipate increases in activity like that experienced in 1987 to be optimistic about the future economic performance of the securities industry. What is needed are periods of more normal levels of activity in the securities markets rather than falloffs in trading values of 25-30% as has happened through most of 1988.

When "normalcy" returns to the capital markets, securities firms will be the beneficiaries. Sooner or later, corporations must seek equity capital. There is a limit to how dependent they can be on debt offerings which has been the case for most of 1988. The American economy has been too innovative to continue to see a lack of IPOs (excluding closed-end bond funds). We also do not think internationalization is a temporary phenomenon and believe that foreign investors will return to the U.S. capital markets in force by acquiring both debt and equity. There are too many positives going for the U.S. capital markets and securities firms for us to be negative, and we refuse to do so.

Jeffrey M. Schaefer
Senior Vice President and
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George R. Monahan
Director of Industry Studies

Grace Toto
Administrative Assistant

APPENDIX A

EMPLOYEES

(In Thousands)

Firm Category	80	81	82	83	84	85	86	87	88*
National Full Line	81.0	92.9	100.3	112.6	122.5	127.5	143.4	146.4	138.6
Large Investment Bks	15.8	17.8	19.9	23.9	25.1	27.0	33.5	38.1	34.2
Regionals	N.A	31.2	31.5	34.3	36.2	35.6	39.2	42.2	40.1
New York City Based	N.A	10.9	10.9	11.2	11.7	12.4	13.3	16.0	15.7
NYSE Discounters	N.A	0.6	1.2	1.6	2.1	2.7	3.8	5.0	4.6
Total Industry	**139.8**	**160.6**	**171.0**	**192.0**	**207.5**	**214.6**	**244.1**	**260.5**	**245.0**

*First Half

EMPLOYEES
1987:3Q - 1988:2Q

Total Industry

	1987: 3Q	1987: 4Q	1988: 1Q	1988: 2Q	Net Change
Producing	96,580	92,316	90,260	88,941	(7,639)
Non-Producing	165,583	168,169	158,104	156,022	(9,561)
Total	262,163	260,485	248,364	244,963	(17,200)

APPENDIX B

STATEMENT OF INCOME
TOTAL SECURITIES INDUSTRY

(In $ Millions)

Revenues	1Q88	2Q88	% Change
Commissions	2,435.0	2,230.8	(8.4)
Trading Profits	3,110.9	2,662.3	(14.4)
Investment Gains	828.8	240.6	(71.0)
Underwriting	1,187.7	1,364.3	14.9
Margin Interest	657.5	697.5	6.1
Mutual Fund Sales	430.0	359.1	(16.5)
Fees, Account Supervision	353.4	486.7	37.7
Research	9.8	5.0	49.0
Commodities	366.7	364.4	(0.6)
Other Securities Related	2,933.1	3,211.4	9.5
Other Unrelated	751.8	828.4	10.2
Total Revenues	13,064.7	12,450.6	(4.7)
Expenses			
RR Compensation	2,053.9	1,916.7	(6.7)
Clerical Compensation	2,486.1	2,326.5	(6.4)
Partner Officer Comp.	355.4	301.8	(15.1)
Other Employee Comp.	139.1	125.6	(9.7)
Floor (Commission Clearing)	444.3	437.3	(1.6)
Communications	611.9	652.4	6.6
Occupancy & Equipment	751.6	776.9	3.4
Promotional Costs	234.6	261.2	11.3
Interest Expense	3,367.5	3,588.6	6.6
Errors Bad Debts	110.3	127.1	15.2
EDP	182.7	181.6	(0.6)
Non-Recurring Charges	11.4	14.1	23.7
Regulatory Fees	87.3	95.1	8.9
Other	1,082.0	1,092.9	1.0
Total Expenses	11,918.1	11,898.1	(0.2)
Pre-Tax Net Income	1,146.6	552.5	(51.8)

APPENDIX C

In issues of Trends, SIA analyzes the financials of the "total securities industry" as well as firm category components. The "total industry" is actually a proxy for the total industry -- it is the New York Stock Exchange (NYSE) member firms which do a public business. SIA and the NYSE maintain a joint database (available to members of either organization) which updates the financials of these groups of firms on a timely, quarterly basis. The data are derived from the regulatory FOCUS (Financial and Operational Combined Uniform Single) Report filed with the NYSE.

As the table below shows, this group of firms, although small in number when compared to all broker-dealers reporting to the Securities & Exchange Commission (SEC), still account for the vast bulk of securities business done in the U.S. Even with the number of all firms reporting to the SEC almost doubling since 1979, and the NYSE group remaining around 400 firms (395 at year-end 1987), the NYSE group has maintained its dominance of the financials. Also, as the table below indicates, all firm data (available only annually) is released quite late -- this issue of Trends covers the NYSE group's performance through the second quarter of 1988, while the SEC released 1987 results in late August -- another reason for using this NYSE group as a proxy for the industry.

NYSE GROUP'S SHARE OF TOTAL INDUSTRY*

(Percent)

Item	79	80	81	82	83	84	85	86	87
Revenues	80	80	81	81	80	79	77	78	77
Assets	84	85	78	86	86	88	87	87	85
Capital	66	65	66	70	71	71	71	71	75
Equity	63	63	65	69	70	68	68	69	71
# of Firms									
NYSE Group	374	389	390	387	412	393	381	417	395
All Firms	4,824	5,283	5,714	6,165	7,374	8,272	8,957	9,436	9,196

*Total industry based on data from the SEC Monthly Statistical Review, August 1988.
NYSE Group: New York Stock Exchange member firms doing a public business.

VOLUME

	JUN 1988	YTD 1988	JUN 1987	YTD 1987	% CHAN YTD 1988-1987
AVERAGE DAILY SHARE VOLUME ON					
NYSE (MILS.)*	195.8	174.7	163.4	179.7	-2.8%
AMEX (MILS.)*	11.8	10.6	12.8	14.1	-24.8%
NASDAQ (MILS.)*	141.6	128.3	149.3	149.4	-14.1%
REGIONAL EXCHANGE (MILS.)*	26.5	24.1	25.6	27.1	-11.1%
DOLLAR VALUE OF SHARES TRADED ON					
NYSE (MILS.)	$142,031	$726,370	$143,548	$931,947	-22.1%
AMEX (MILS.)	3,216	16,772	4,243	27,285	-38.5%
ODD LOT SHARES PURCHASED ON NYSE (THOUS.)	7,326	44,156	9,271	65,627	-32.7%
ODD LOT SHARES SOLD (INCLUDING SHORT SALES) ON NYSE (THOUS.)	16,528	89,734	15,562	107,334	-16.4%
NYSE BLOCK VOLUME AS A PERCENT OF TOTAL SHARES TRADED	60.6%	52.4%	52.8%	51.1%	----
CONTRACTS TRADED (THOUS.)					
CBOE OPTIONS	10,404	54,932	13,190	97,305	-43.5%
AMEX OPTIONS	3,830	19,175	4,181	26,333	-27.2%
COMMODITY	26,532	122,604	20,046	112,339	9.1%

*MONTHLY AVERAGE
N/A - DATA NOT AVAILABLE

PRICES
(END OF MONTH)

	JUN 1988	JUN 1987	% CHAN JUN 1988-1987
DOW JONES INDUSTRIALS	2141.71	2418.53	-11.45%
STANDARD & POOR'S 500	273.50	304.00	-10.03%
NYSE COMPOSITE	154.47	171.07	-9.70%
AMEX MARKET VALUE INDEX	309.25	338.13	-8.54%
VALUE LINE COMPOSITE	240.04	268.59	-10.63%
NASDAQ COMPOSITE	394.66	424.67	-7.07%

YIELDS

(MONTHLY AVERAGES)

	JUN 1988	JUN 1987	BASIS POINT CHG 1988-1987
BOND BUYER INDEX (20 BOND)	7.78%	7.79%	(1)
CORPORATE BOND YIELDS (MOODY'S)			
Aaa CORPORATE	9.86	9.32	54
Baa CORPORATE	11.00	10.52	48
RATIO Aaa CORPS. TO Baa CORPS.	0.90	0.89	1

UNDERWRITING

	FIRST HALF 1988	FIRST HALF 1987	% Change 1988-1987
CORPORATE FINANCING (Gross New Issues - $ Mils)			
TOTAL	$143,760.7	$150,220.7	-9.1%
Common Stock	$16,033.7	$25,591.6	-37.3%
# of Common Stock Issues	196	512	-61.7%
Preferred Stock	$3,414.3	$6,983.2	-51.1%
# of Preferred Stock Issues	61	96	-36.5%
Corporate Debt	$124,312.8	$125,646.0	-1.1%
# of Corporate Debt Issues	1,543	1,321	16.8%
MUNICIPAL FINANCING (Gross New Issues - $ Mils)			
Negotiated	$38,195.9	$44,652.2	-14.5%
# of Issues	1,525	1,776	-14.1%
Competitive	$13,976.2	$13,281.3	5.2%
# of Issues	1,604	1,821	-11.9%

Source: IDD Information Services

RECENT INTERESTING READING AND STATISTICAL MATERIAL

Item	Description	Source
THE BUDGET DEFICIT The Causes, The Costs, The Outlook	Economist Leonard J. Santow, Ph.D., examines the causes and outlook of the federal deficit including: "party-in-power" factors; Gramm-Rudmann-Hollings; usefulness of the debt ceiling; impact of current Treasury financings on future debt management; is a balanced budget amendment feasible; relationship between deficits and interest rates; budgetary policies and timing of budget submissions, and much more useful facts and insight into the deficit problem today.	1988 New York Institute of Finance, Publishing & Professional Information Services New York, New York
"Global Equity Analysis Report"	This new SIA report is designed as a tool for determining the direction and volume of global equity flows. It delineates the growth in international equity trading; volume activities in foreign equities by Canadian, West German, United Kingdom, Japanese and United States investors, and much more with analysis by SIA's Research Department.	SIA Research Department
"Distributional Aspects of a Federal Value-Added Tax"	Using a newly-developed measure of income, this article evaluates the regressivity of this tax (a barrier to its political acceptability), analyzes options for reducing this regressivity, analyzes the usefulness of this tax in reducing the deficit without adversely affecting savings,	National Tax Journal June, 1988
"Basket Investing: The New Force in the Stock Market"	Two-part article on how markets have shifted from stocks trading on their own merits to basket trading of securities. Topics discussed include: fears by individuals, institutions and regulators; index funds; effect on capital-raising function, and the response by the exchanges themselves.	Institutional Investor September, 1988

RECENT INTERESTING READING AND STATISTICAL MATERIAL

Item	Description	Source
"Commercial Banking Performance - Second Quarter 1988"	FDIC quarterly report shows commercial banks earning record profits in 1988's first half as well as the second quarter. Despite banking industry earnings' drags from problem banks, particularly in Texas, report shows banking industry's rebound from periods of LDC writedowns.	FDIC Quarterly Banking Profile Second Quarter, 1988
Japan M&A Reporter	This bi-monthly newsletter covering U.S./Japan M&A activity discusses a pickup in U.S. companies' Japan subsidiaries/joint ventures plans for IPOs in Tokyo over the 1988-90 period. Includes listings of completed or pending acquisitions, IPOs, investments joint ventures and real estate deals.	Ulmer Brothers, Inc. New York, New York
The Spicer & Oppenheim Guide to Securities Markets Around the World	Second edition guide to 26 of the most important securities markets in the world including updated information on size of markets, tax developments, settlement and clearing arrangements, new issues, futures and options markets, etc.	John Wiley & Sons New York, New York
"Resolving the Tax Issues Arising in Bank Rescues"	Article describing the FDIC's treatment of the NCNB Corp.'s takeover of First RepublicBank Corp. and the conclusion that the IRS's rulings were a movement forward in resolving tax issues in bank takeovers but that legislation will be needed to achieve certainty in tax issues regarding these transactions	Tax Notes 9/26/88